Indiana's Municipal Funding Dilemma and Options for Re-working the System

Indiana Association of Cities and Towns

September 29, 2014

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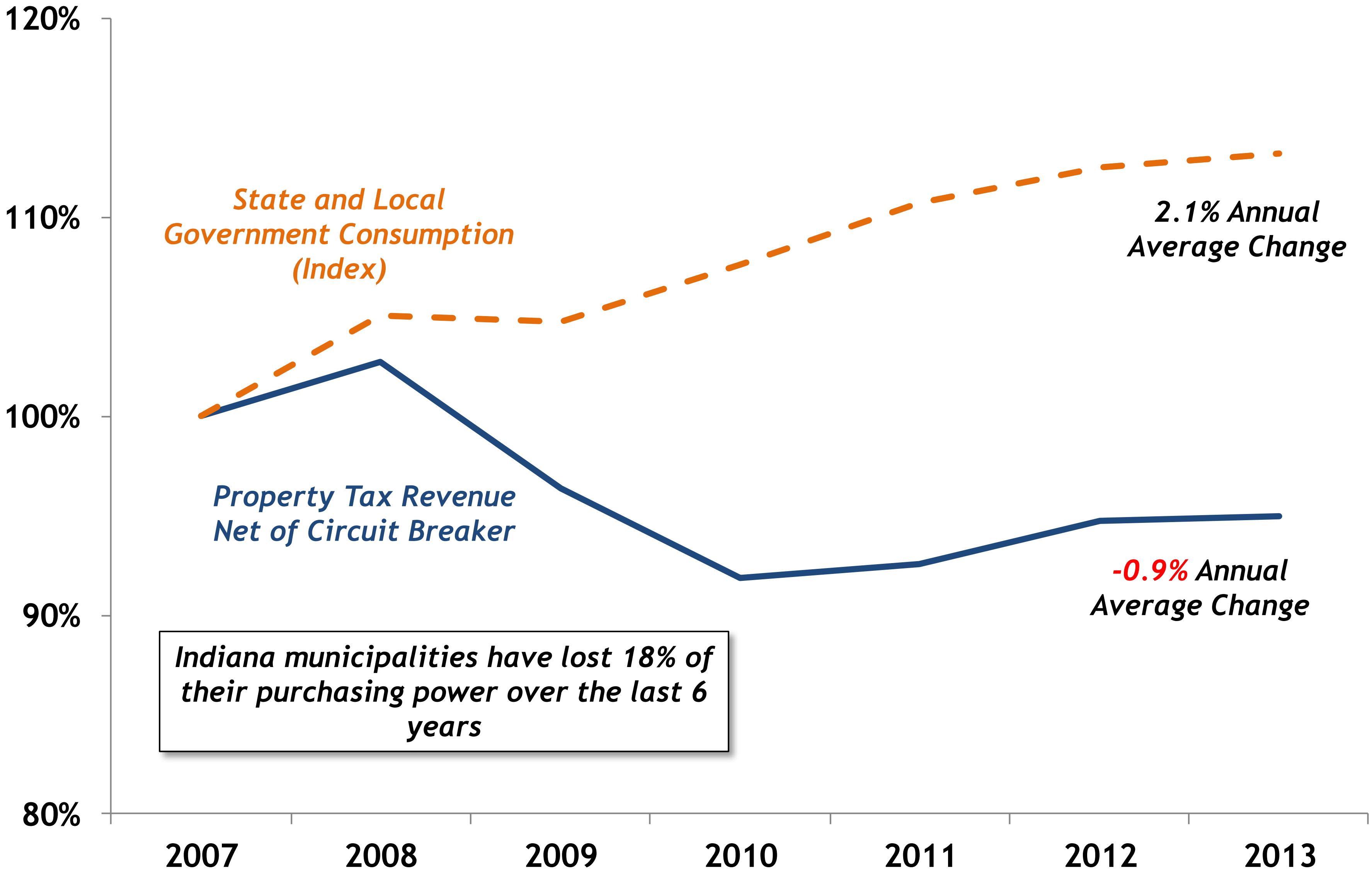
PolicyAnalytics, LLC

Agenda

- How Did We Get Here?
- How Have Municipalities Been Affected?
- What Does this Mean for the Future?
- What Options can be Explored?

Property Tax Revenue vs. Cost of Delivering Services

All Indiana Municipalities



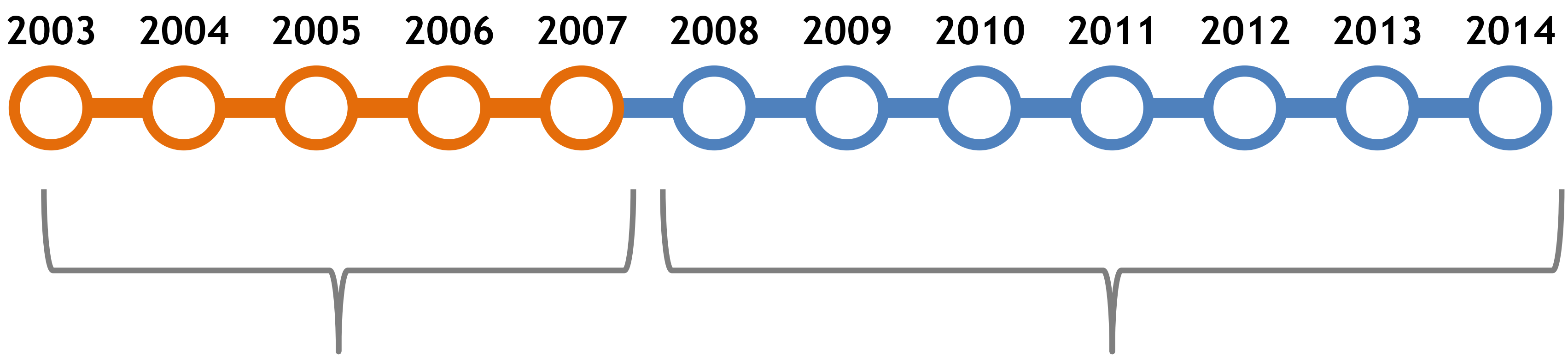
The New Local Government Finance Landscape

- In 2008, property tax reform was enacted to lower taxes, and make tax bills more predictable for taxpayers.
- The property tax reforms reduced revenue to taxing units, and restricted the potential for future property tax revenue growth.
- Local government has reduced reliance on property taxes, but increased reliance on income taxes.
- In 2007, 80% of local budgets were funded by property taxes. Today 39% of all local budgets (including public schools) and 60% of all municipal budgets are funded through property taxes
- Today, all 92 counties have implemented LOITs that are expected to generate $1.874 billion for local budgets, capital projects, and property tax relief in 2014.

How Did We Get Here?

A Timeline of Property Tax Policy Change in Indiana

Property Tax Policy in Indiana
Recent History



Transition to Market Value Assessment

Property Tax Reform and Introduction of Circuit Breaker Credit

Transition to Market Value Assessment

2003 — 2004 — 2005 — 2006 — 2007

Switch to Market Value Assessment

- In 1998, the Indiana Supreme Court found that Indiana's method of replacement cost valuation was unconstitutional.
- All real property was reassessed using 1999 market values for taxes payable in 2003.
- Homestead deduction was increased to $35K

Transition to Market Value Assessment

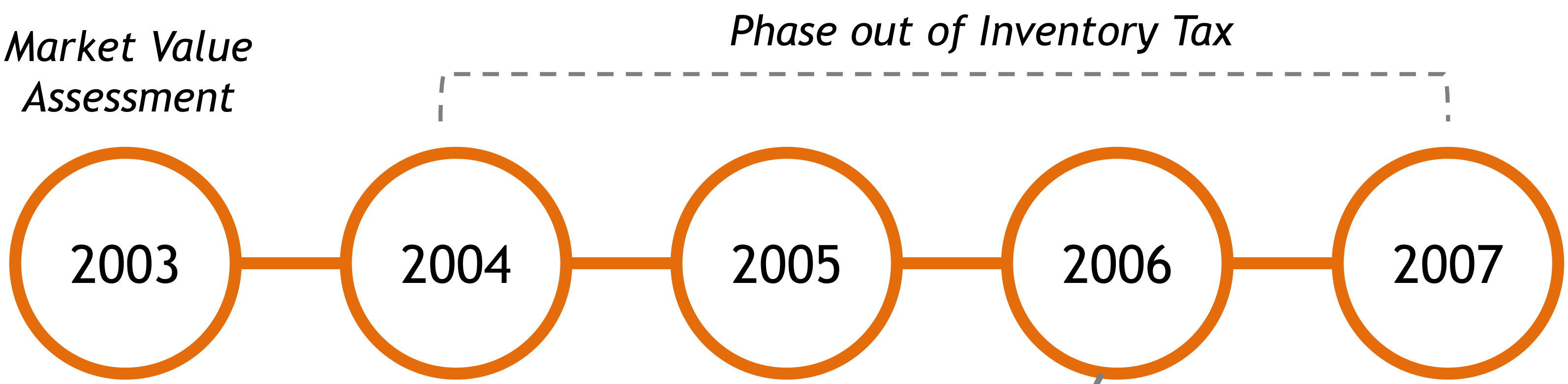
Market Value Assessment

2003 — 2004 — 2005 — 2006 — 2007

Continued changes to the system

- Counties were given the option to remove inventory from the tax base (required by 2007).
- Banked levies were eliminated, removing an option of reserve funding for units.

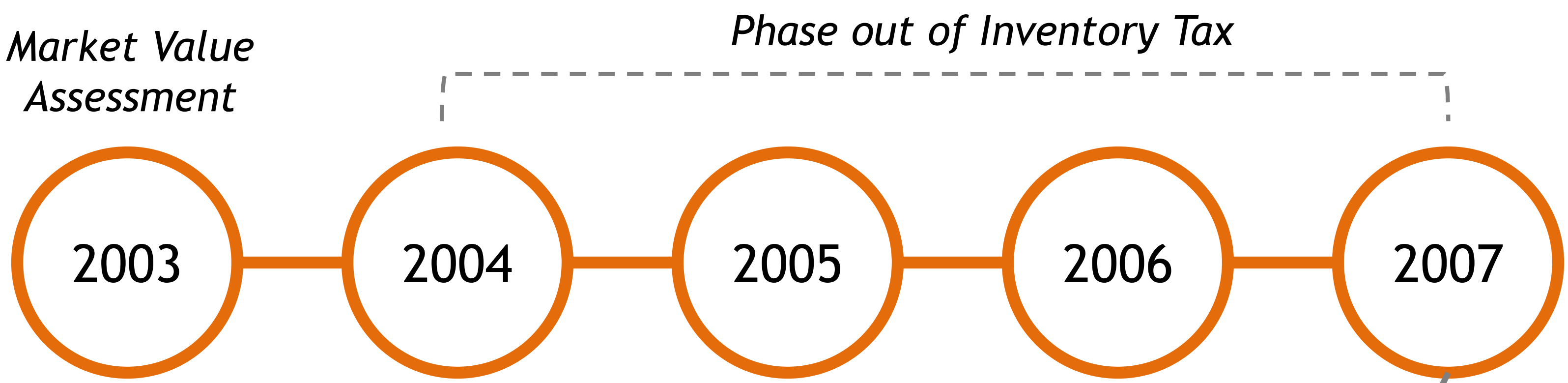
Transition to Market Value Assessment



Circuit Breaker appears in Statute

- Property tax rate caps or “circuit breakers” were introduced for the first time – to begin in 2008.
- Rates would be capped at 2% for homesteads, and 3% for all other properties, when fully implemented.

Transition to Market Value Assessment



Property Tax "Crisis"

- Statewide trending resulted in significant property tax increases for residential taxpayers.
- Inventories were fully exempted from the tax base (approx 4.7% of NAV)
- Limits were placed on State property tax relief.
- General Assembly issued one-time homestead rebate to offset increases.
- Max levy banking re-introduced (at 50%)
- Std. Deduction increased to $45K (3.5% of NAV)

Impact of Trending in Payable 2007

Market value changes between March 1, 1999 and March 1, 2006 (six years) were incorporated into AV's in a single tax year.

Change in Average Homestead Gross AV

	2005-06	2006-07	Pct. Change
Fort Wayne	86,831	111,616	29%
Goshen	102,048	116,237	14%
Hammond	80,441	91,795	14%
Crawfordsville	78,788	96,238	22%
Shelbyville	84,840	97,141	14%
Lawrence	125,056	148,420	19%

2007 Property Tax Crisis

Marion County's average homestead property tax bill increased by 24% between 2006 and 2007.

- Elimination of Inventory Assessments: **4%**
- Cap on State Property Tax Relief: **4%**
- General Reassessment and Trending: **10%**
- Increase in Local Spending: **6%**

Source: Central Indiana Corporate Partnership

Property Tax Reform and Circuit Breaker Credits

2008 — 2009 — 2010 — 2011 — 2012 — 2013 — 2014

Property Tax Reform Legislation

- HEA 1001-2008 created the 1%, 2%, 3% circuit breaker credit among other property tax changes.
- Introduction of the supplemental standard deduction in statute.
- An additional one-year $620M, state-funded homestead credit was introduced to provide tax relief in 2008.

Major Provisions of HEA 1001-2008

Expansion of the Circuit Breaker Credit

- 1% for homestead property
- 2% for non-homestead residential, farm land, and long-term care
- 3% for all other property
- Additional limits for seniors

Significantly altered State funding of local units

- Eliminated PTRC; phased out homestead credit
- Shifted school general fund, county welfare, and public safety pension responsibilities to State

Other Changes

- Introduction of the Supplemental Standard Deduction
- Increased Standard Deduction to 60% of GAV, up to $45K
- Referendum requirement for large capital projects
- Increase in State sales tax

Property Tax Reform and Circuit Breaker Credits

Property Tax Reform Passed

2008 — 2009 — 2010 — 2011 — 2012 — 2013 — 2014

First effects of HEA 1001-2008

- State assumes school funding, county welfare funding responsibilities.
- Circuit breaker credits are phased in, fully implemented in 2010.
- Supplemental Standard Deduction results in a 14% reduction in the statewide property tax base.

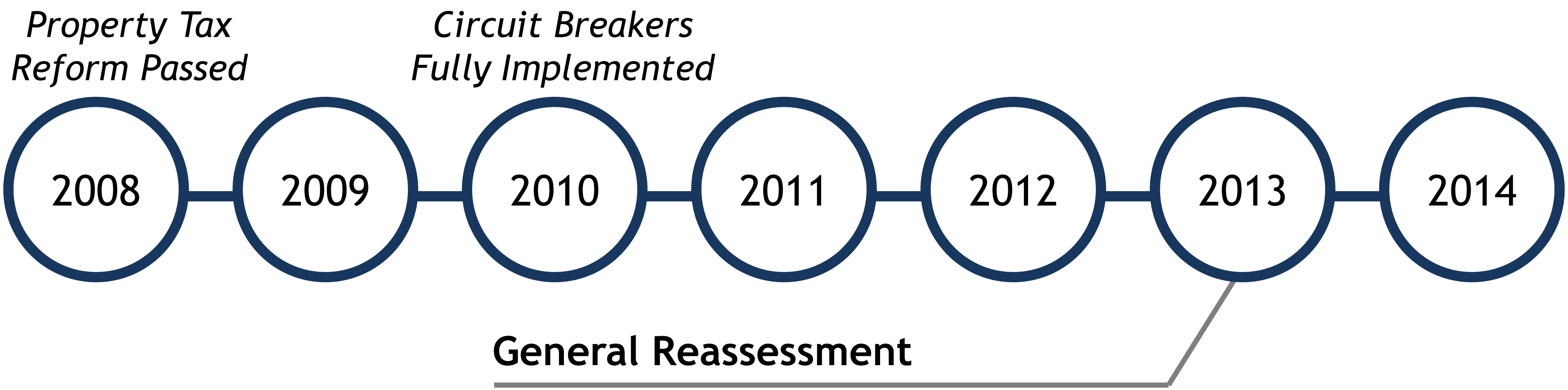
Property Tax Reform and Circuit Breaker Credits

Property Tax Reform Passed

Circuit Breaker fully implemented

- Circuit breaker caps are fully implemented at 1%, 2%, and 3% of gross assessed value.

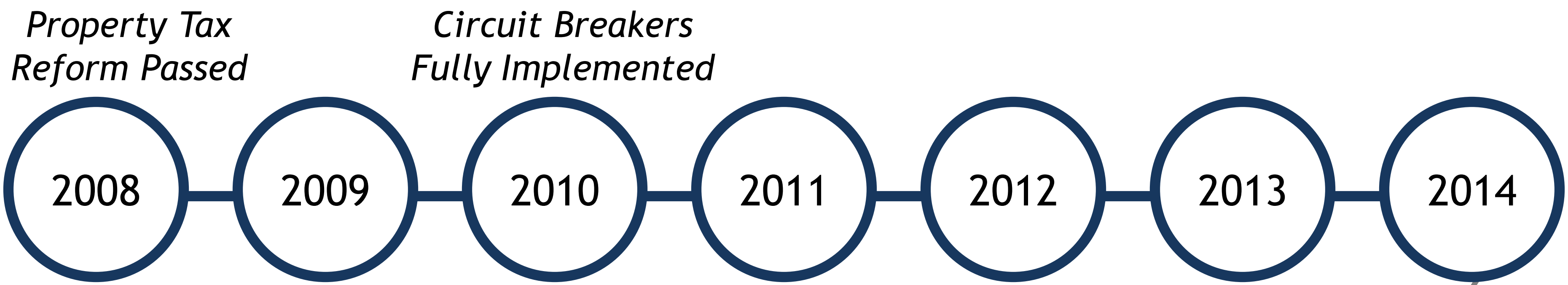
Property Tax Reform and Circuit Breaker Credits



General Reassessment

- Taxes payable in 2013 incorporated the effects of the 2007-2010 national recession.
- Caused significant reductions in the value of commercial and industrial property.

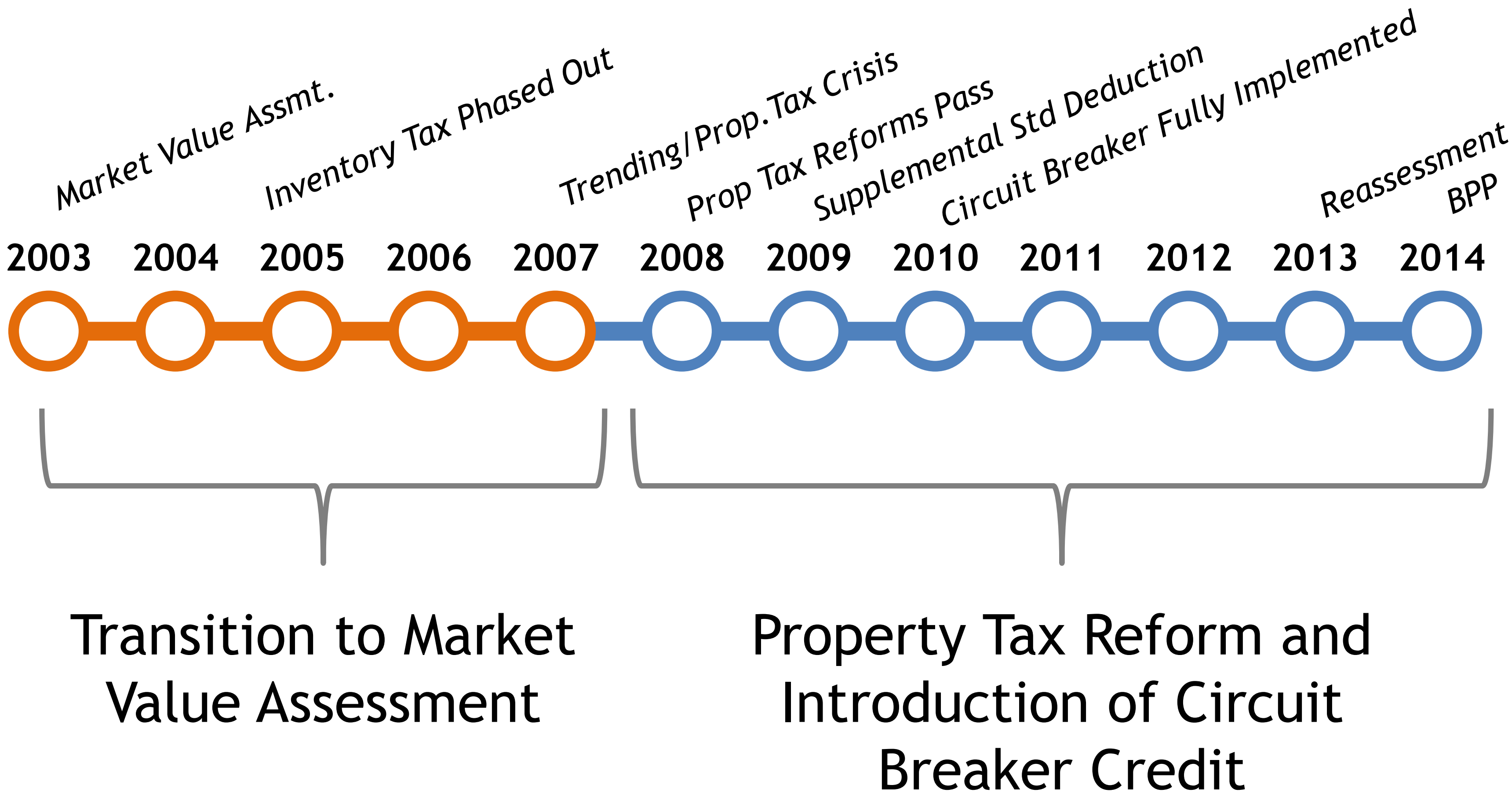
Property Tax Reform and Circuit Breaker Credits



Business Pers. Property Legislation

- County option to exempt small returns (<$20K)
- County option to exempt new personal property
- Exemptions may begin with taxes payable in 2017
- Enhanced personal property abatement (20 years)

Property Tax Reform Timeline



What Does this Mean to Taxpayers and Taxing Units?

Benefits to Taxpayers

The circuit breaker caps were introduced in response to property tax increases experienced by taxpayers in 2007.

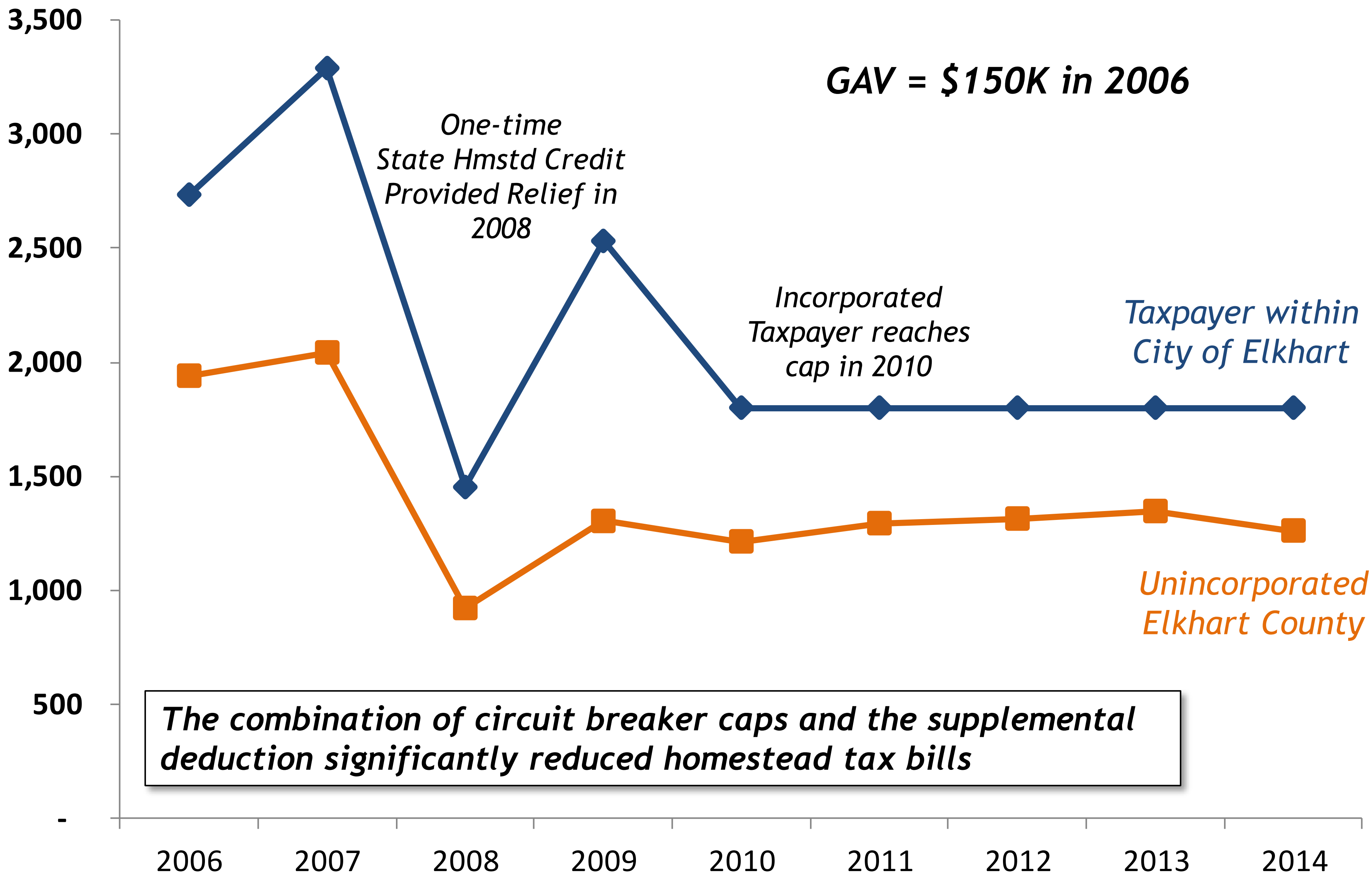
- Circuit Breaker tax cap limits were intended to provide property tax relief – reducing the property tax bill for taxpayers.
- Circuit breaker caps were intended to make tax bills more consistent and predictable for taxpayers.
- The circuit breaker provisions received widespread popular support, and were amended into the Indiana Constitution.

Did the legislation achieve these goals?

…and what were the results to local units?

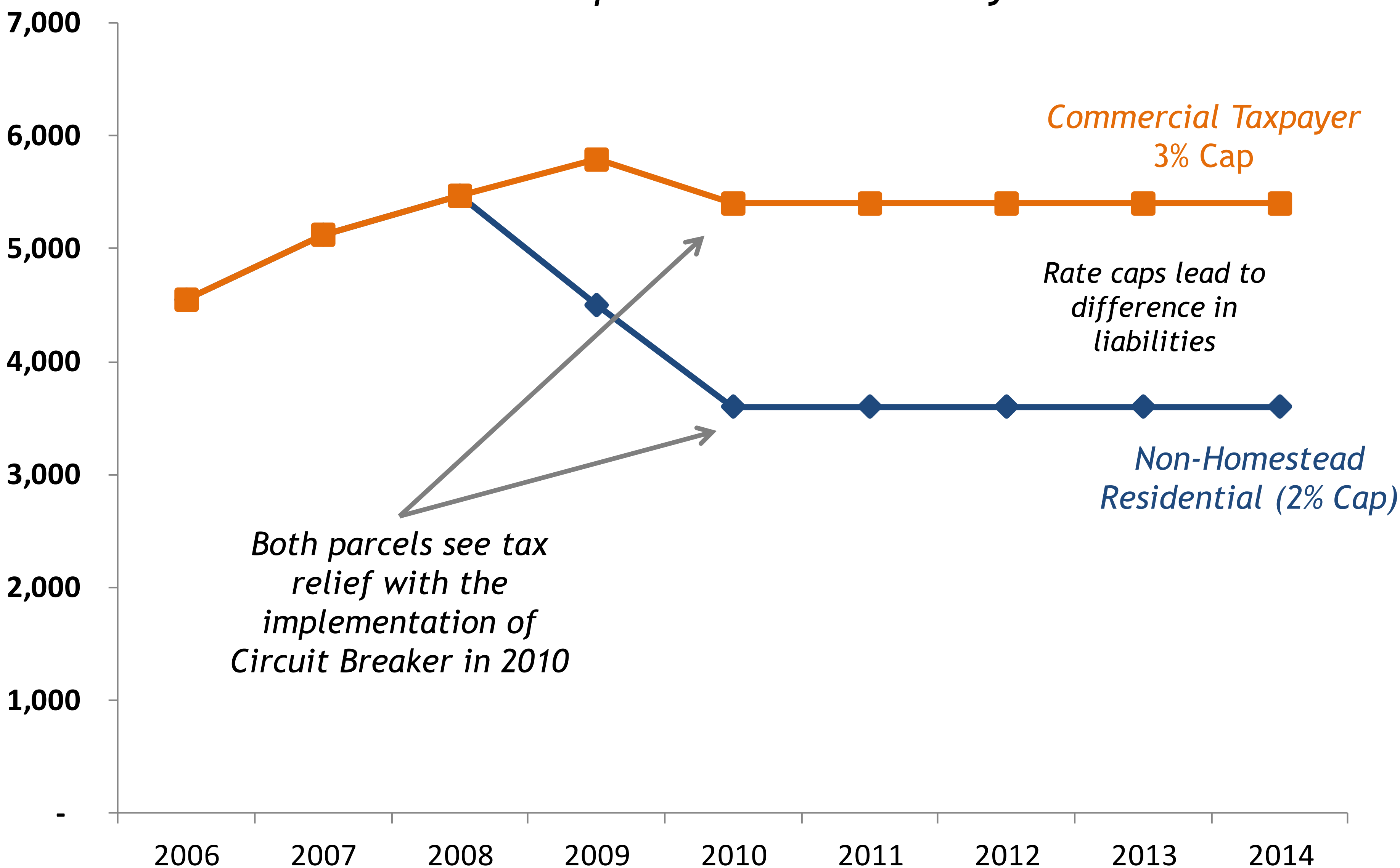
Impact to Homestead Taxpayers

Illustrative Impact in Elkhart County

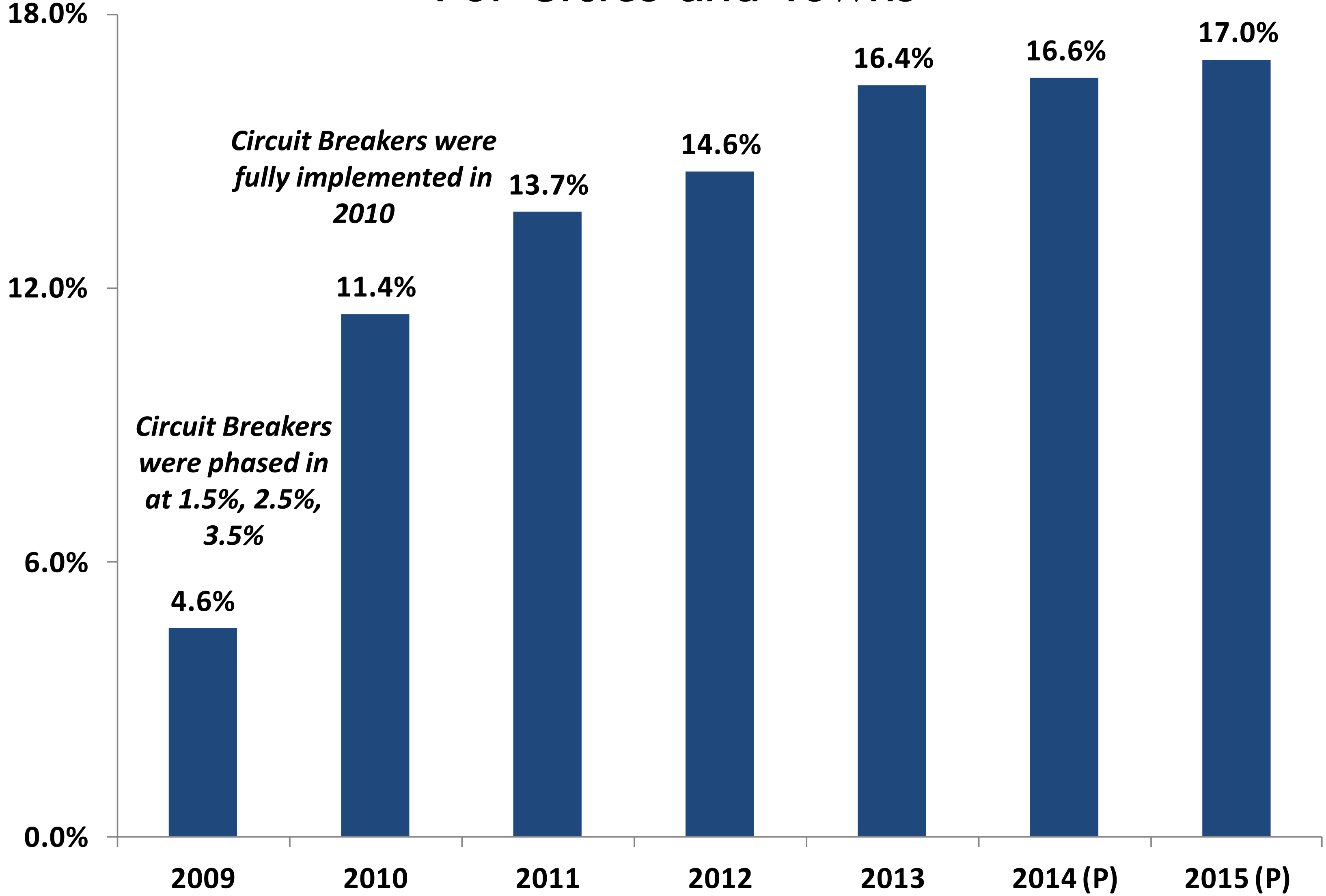


Impact to Rental and Commercial Taxpayers

Illustrative Impact in Elkhart County



Circuit Breaker Loss as a Percent of Certified Levy
For Cities and Towns



Projections from Legislative Services Agency, 2013

Indiana's Tax Rate Caps

Indiana's property tax caps are very different from all others in two important aspects:

- Circuit Breaker tax cap limits the total tax rate and not the rates of individual taxing units.
- Revenue losses resulting from the Circuit Breaker tax cap are not funded.

Once a taxpayer reaches the tax cap, any increase in the tax rate of any taxing unit, reduces the available funds for all other another taxing units.

What Drives the Circuit Breaker?

- Location: Incorporated vs. Unincorporated
- Changes in Assessed Value
- Municipal Levy Decisions
- Levy Changes for Other Overlapping Units

District Property Tax Rate Calculation

$$\frac{\text{Levy: } \$100{,}000{,}000}{\text{NAV: } \$3{,}000{,}000{,}000} = \$3.3333$$

Effective Circuit Breaker Rate Cap Thresholds

District Tax Rate Required to Reach the Tax Cap

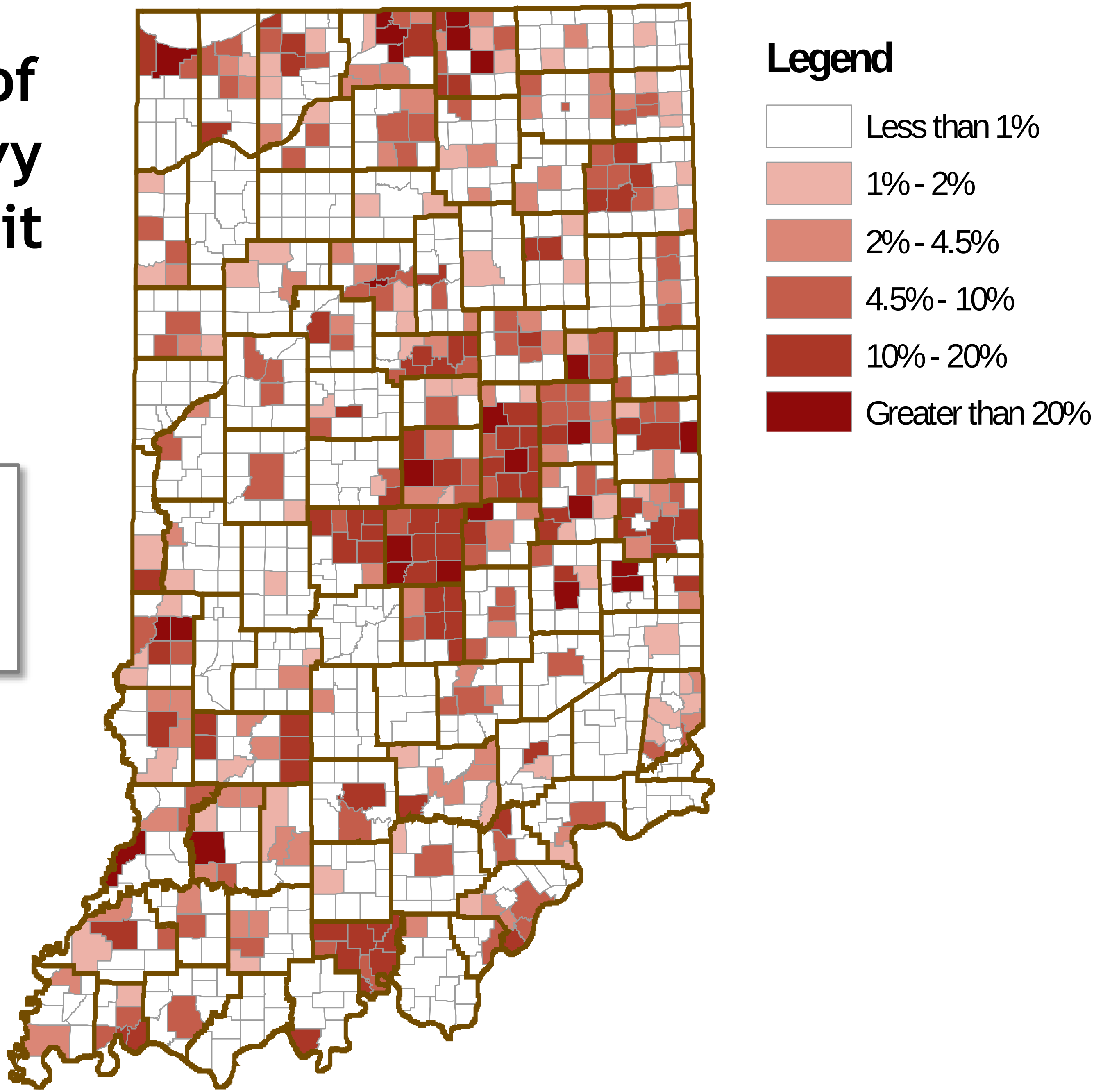
Homesteads

- $125K: $2.5510
- $225K $2.0460
- $350K $1.7926

Non-Homesteads

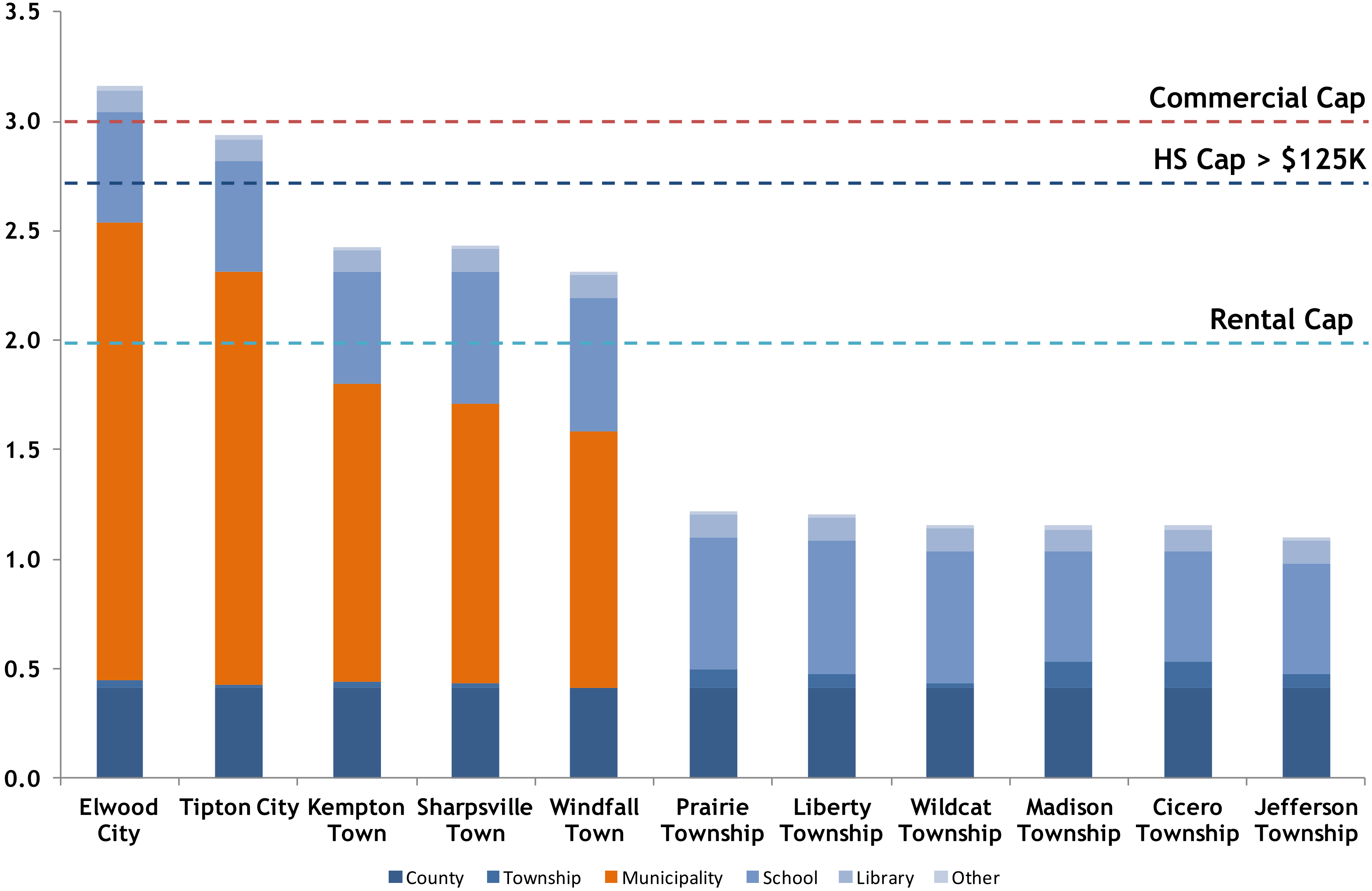
- Rental/Farmland: $2.0000
- Commercial: $3.0000

Percentage of Certified Levy Lost to Circuit Breaker



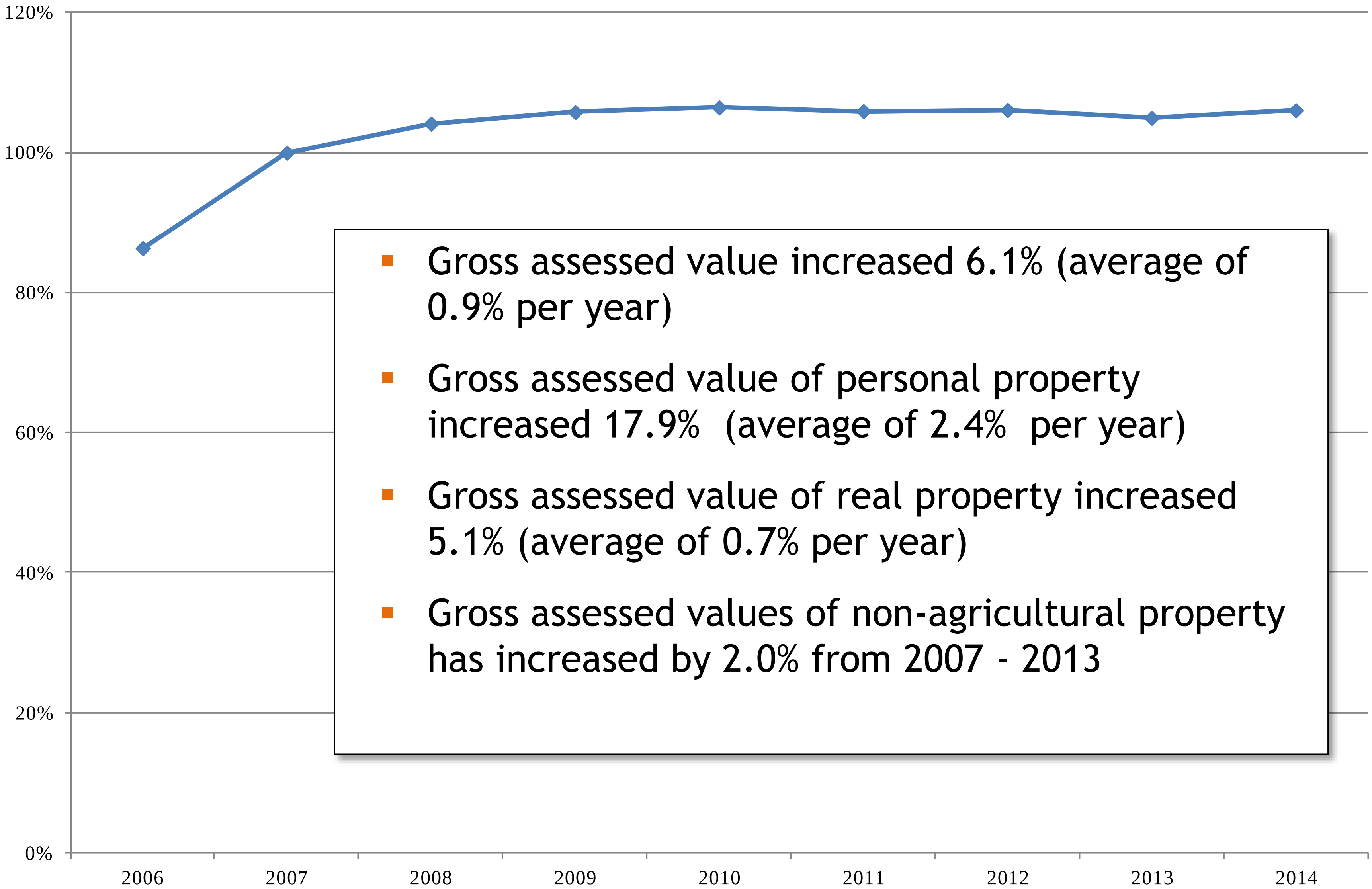
Circuit breaker losses are concentrated in incorporated areas

District Tax Rates for Tipton County



Statewide Change in Gross AV

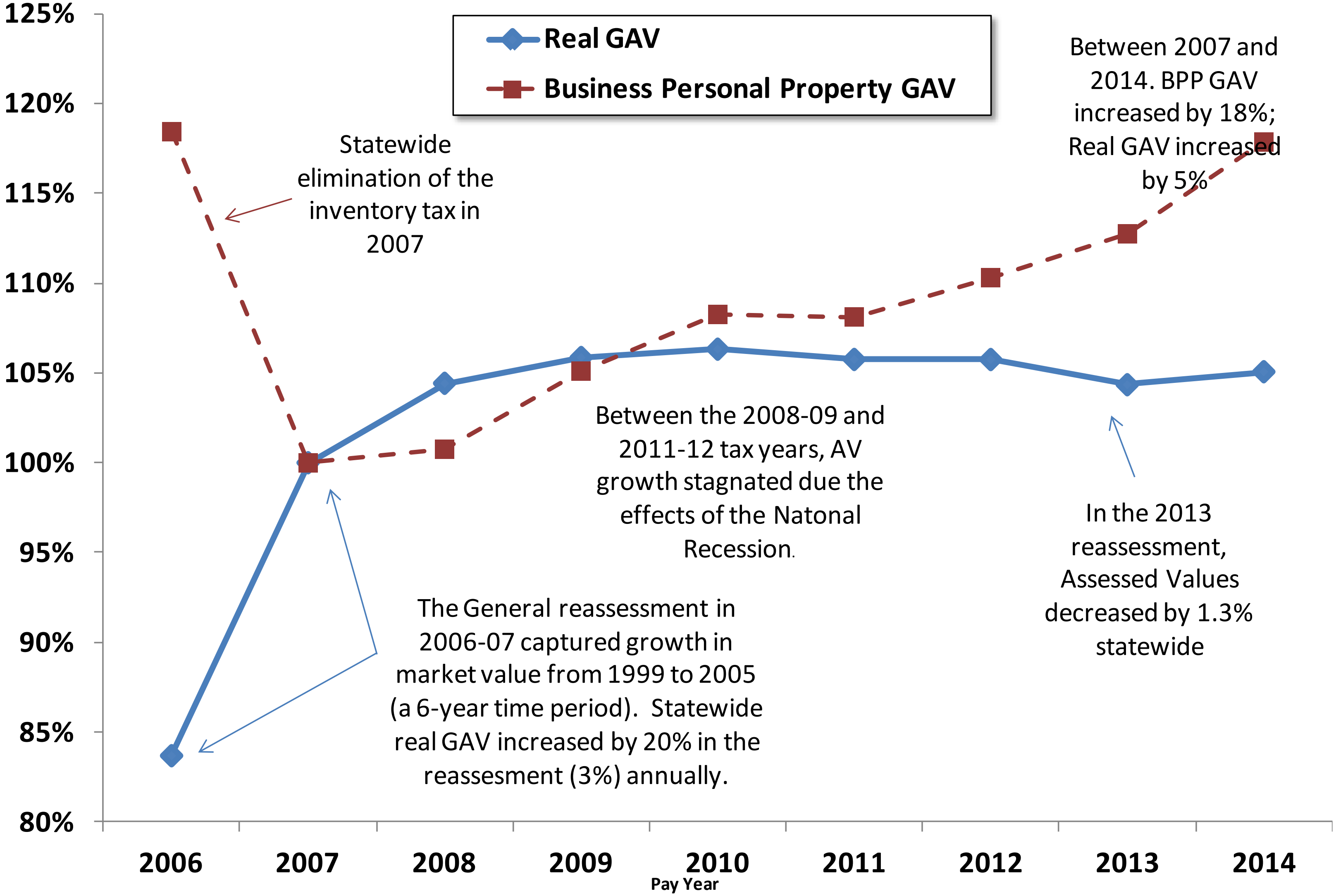
Indexed to 2007



- Gross assessed value increased 6.1% (average of 0.9% per year)
- Gross assessed value of personal property increased 17.9% (average of 2.4% per year)
- Gross assessed value of real property increased 5.1% (average of 0.7% per year)
- Gross assessed values of non-agricultural property has increased by 2.0% from 2007 - 2013

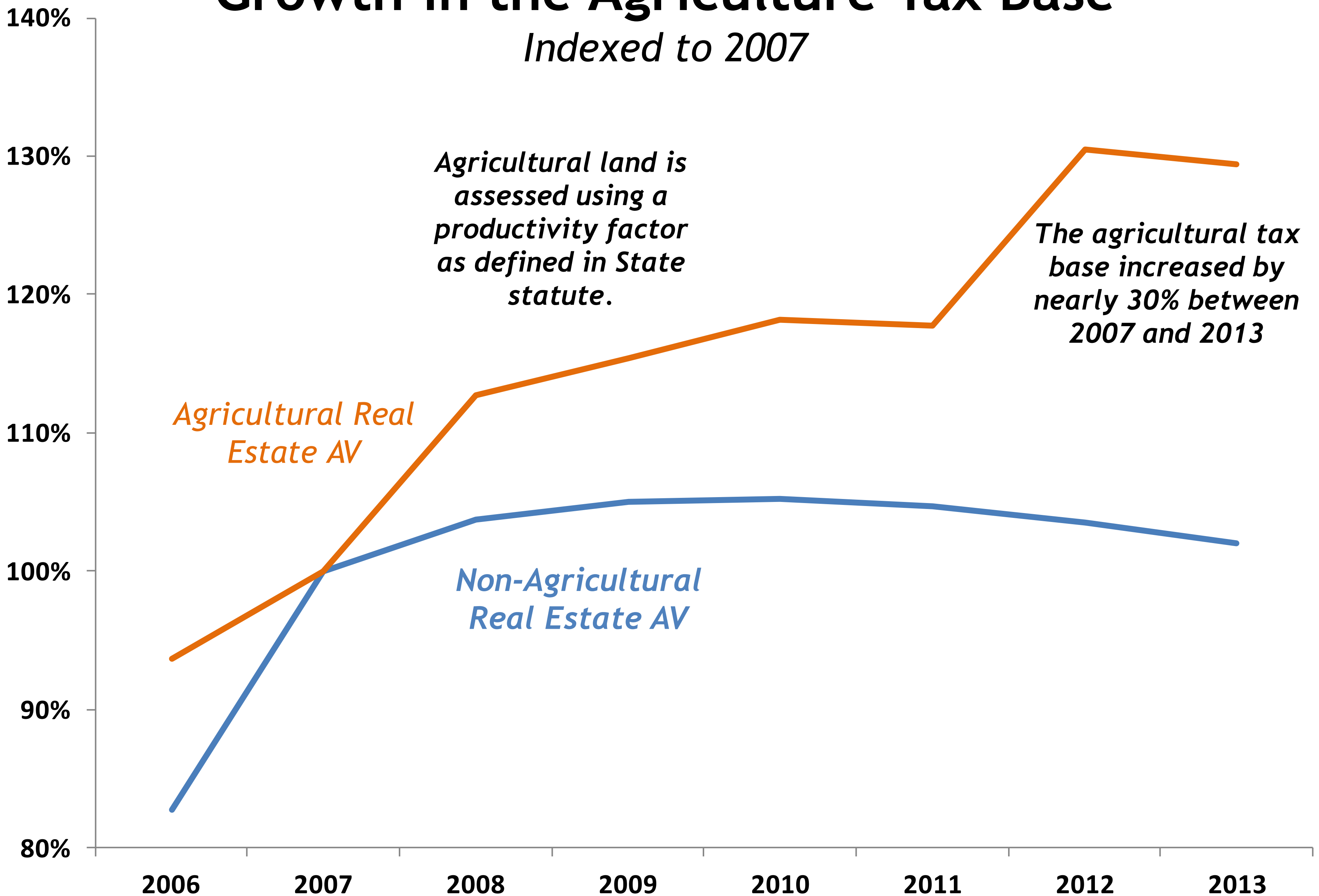
Real AV vs. BPP AV

Indexed to 2007



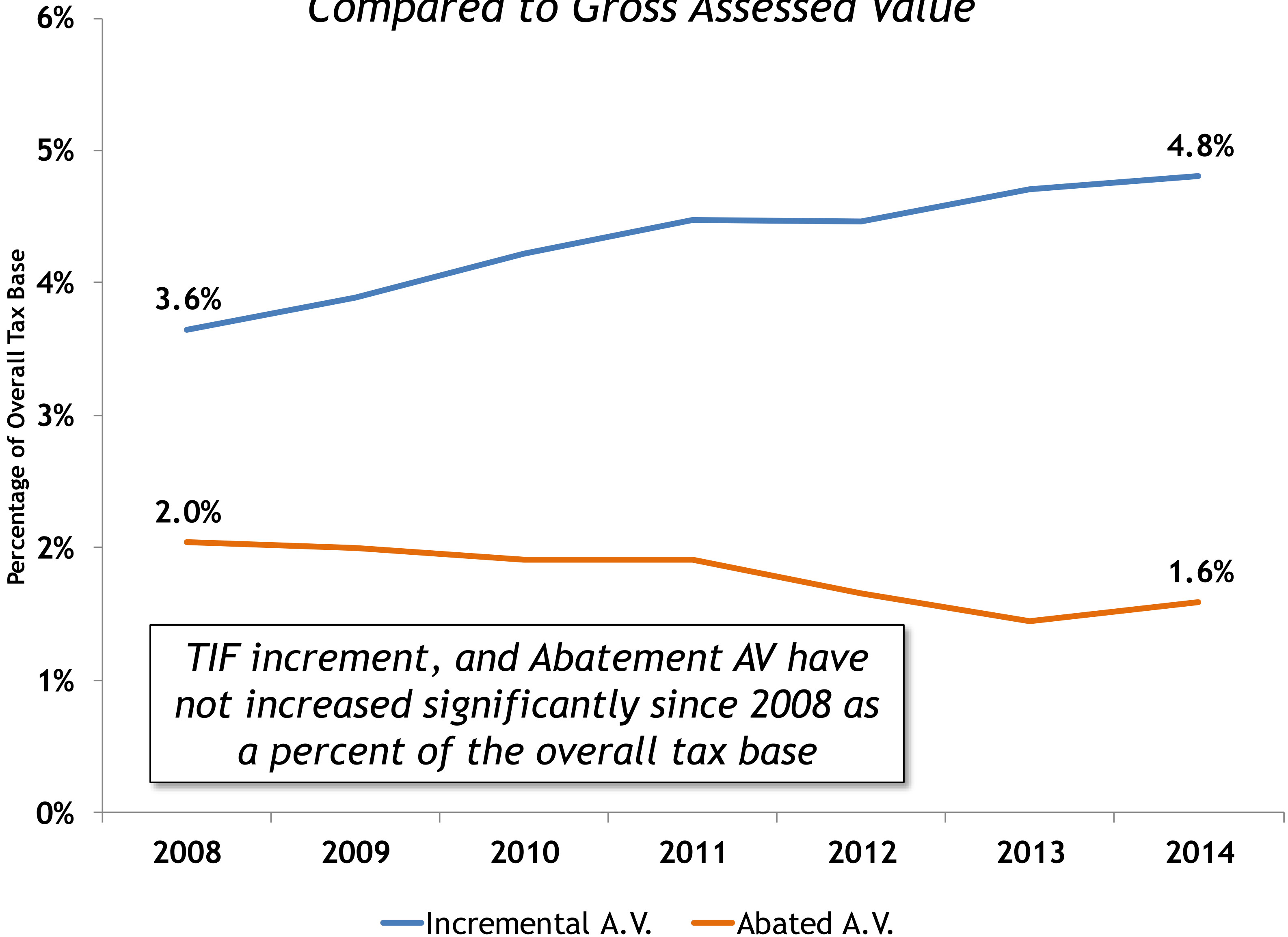
Growth in the Agriculture Tax Base

Indexed to 2007



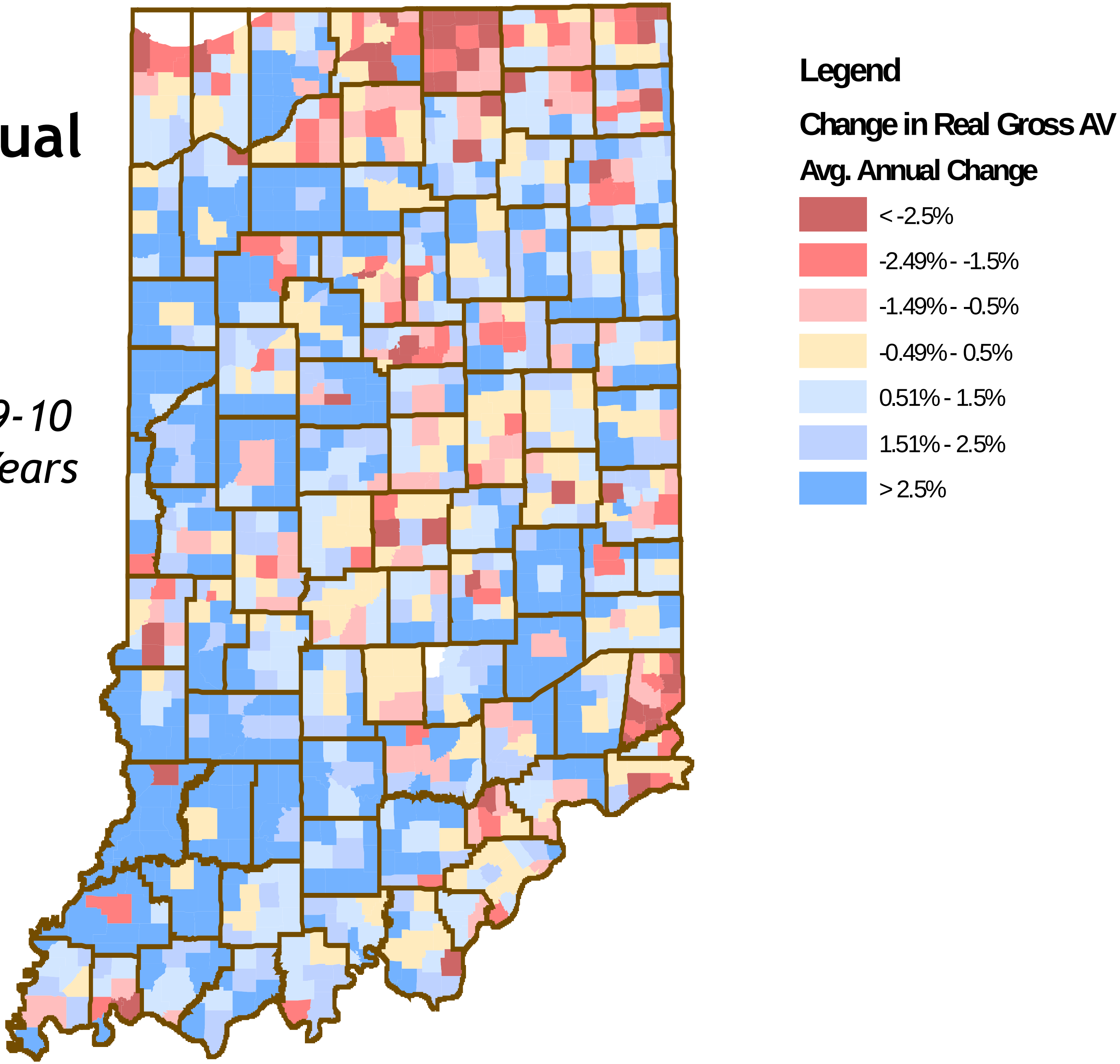
TIF Increment and Abatement AV

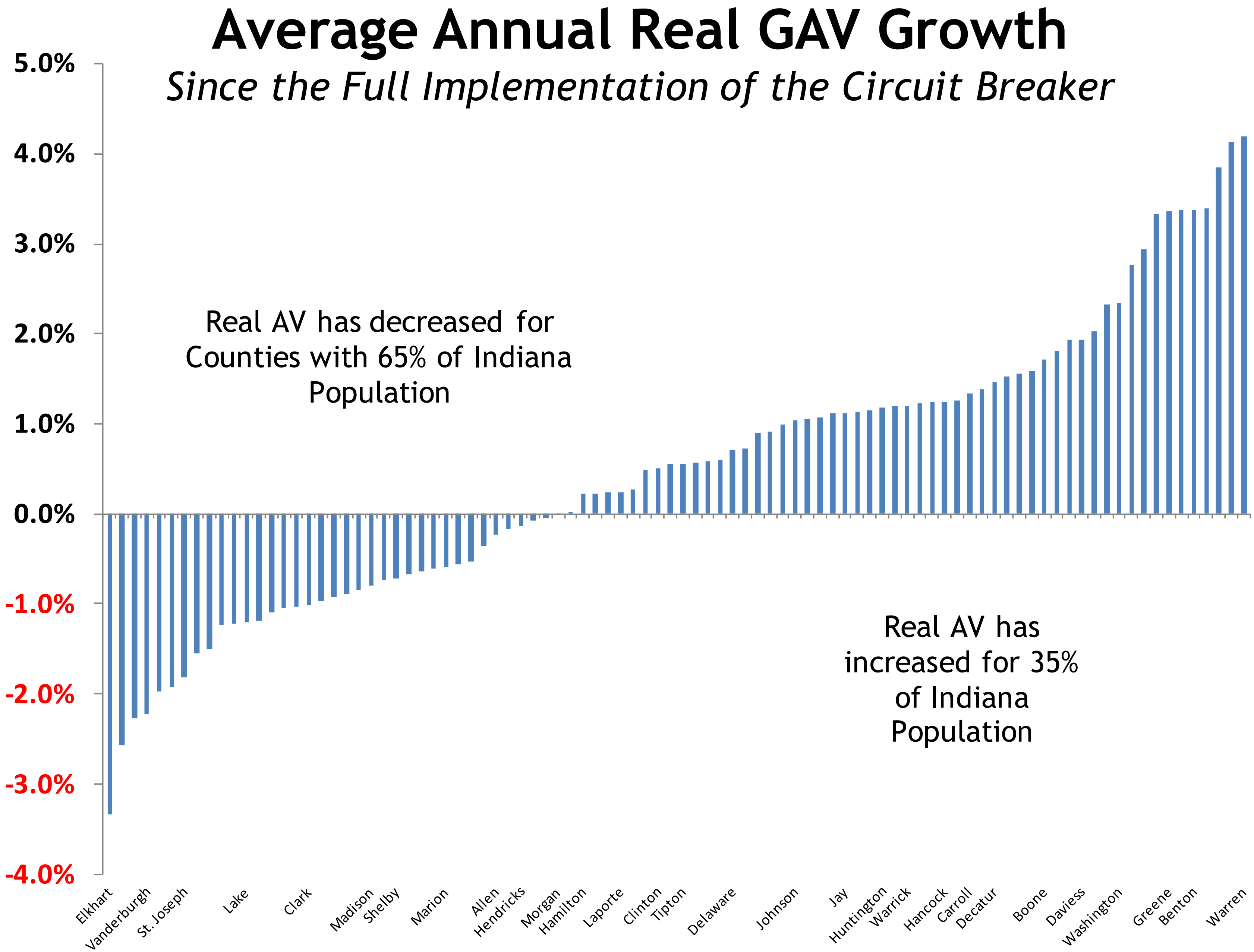
Compared to Gross Assessed Value



Average Annual Change in Gross AV

Between the 2009-10 and 2013-14 Tax Years




Average Annual Real GAV Growth
Since the Full Implementation of the Circuit Breaker
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
-3.0%
-4.0%
Real AV has decreased for Counties with 65% of Indiana Population
Real AV has increased for 35% of Indiana Population
Elkhart
Vanderburgh
St. Joseph
Lake
Clark
Madison
Shelby
Marion
Allen
Hendricks
Morgan
Hamilton
Laporte
Clinton
Tipton
Delaware
Johnson
Jay
Huntington
Warrick
Hancock
Carroll
Decatur
Boone
Daviess
Washington
Greene
Benton
Warren

Tax Base Implications

- Communities with greater populations tend to have higher percentage circuit breaker losses.
- The 25 municipalities with the highest circuit breaker tax impact have losses ranging from 25% to 50% of their levy.
- The average losses for these cities have grown from 10% to over 30% of the levy, by 2013.

These losses have been increasing each year and will continue to grow over time. Growth in assessed value simply has not kept pace with growth in levies.

Municipal Levy Decisions

Circuit Breaker is essentially a function of the tax rate and tax base composition

- For circuit breaker affected units, a levy increase, in excess of assessed value growth **will** result in a circuit breaker increase.
- This circuit breaker increase will be spread across all overlapping taxing units.

Where does the revenue to fund a levy increase originate?

- From taxpayers, from those that are still below the cap.
- From other units of government, if taxpayers have reached the cap.

Illustration of Unit Interactions: Case A

Example: Coffee Shop with an Assessed Value of $100K

Unit Type	Rate
County	0.5000
Township	0.1000
Municipality	1.5000
School	1.0000
Library	0.2500
District Rate	**3.3500**

Tax rate exceeds 3%. Parcel hits the circuit breaker cap and pays a max of $3K

Distribution of Tax Payment

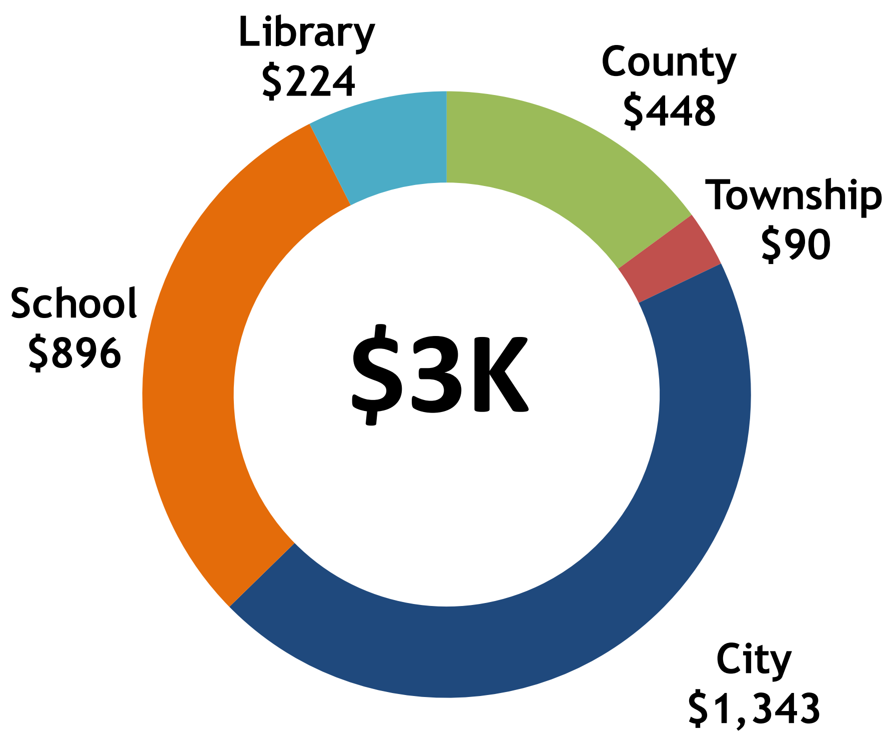


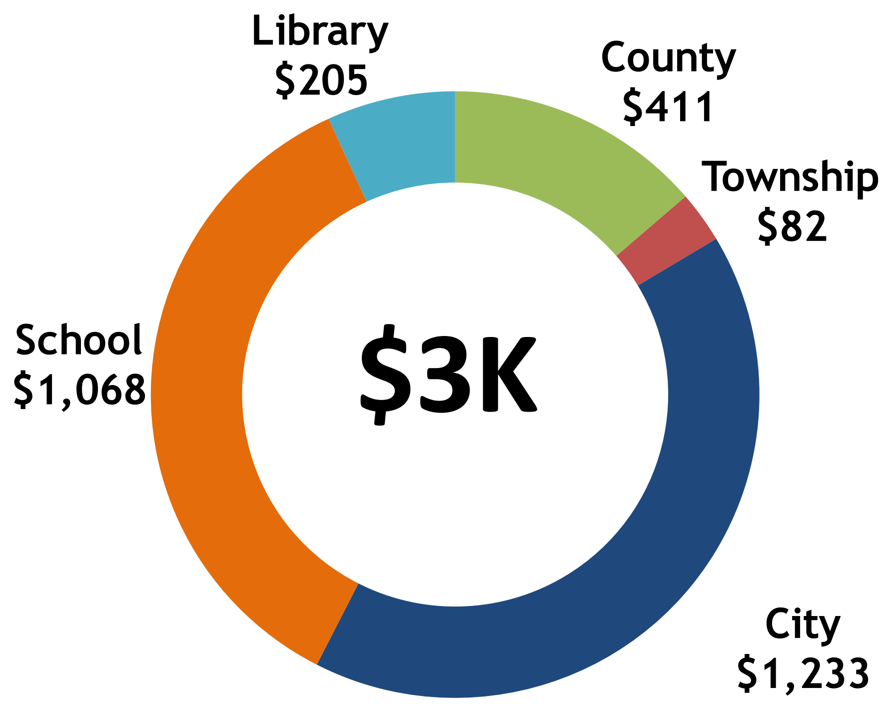
Illustration of Unit Interactions: Case B

Example: Coffee Shop with an Assessed Value of $100K

Unit Type	Rate
County	0.5000
Township	0.1000
Municipality	1.5000
School	1.2000
Library	0.2500
District Rate	**3.5500**

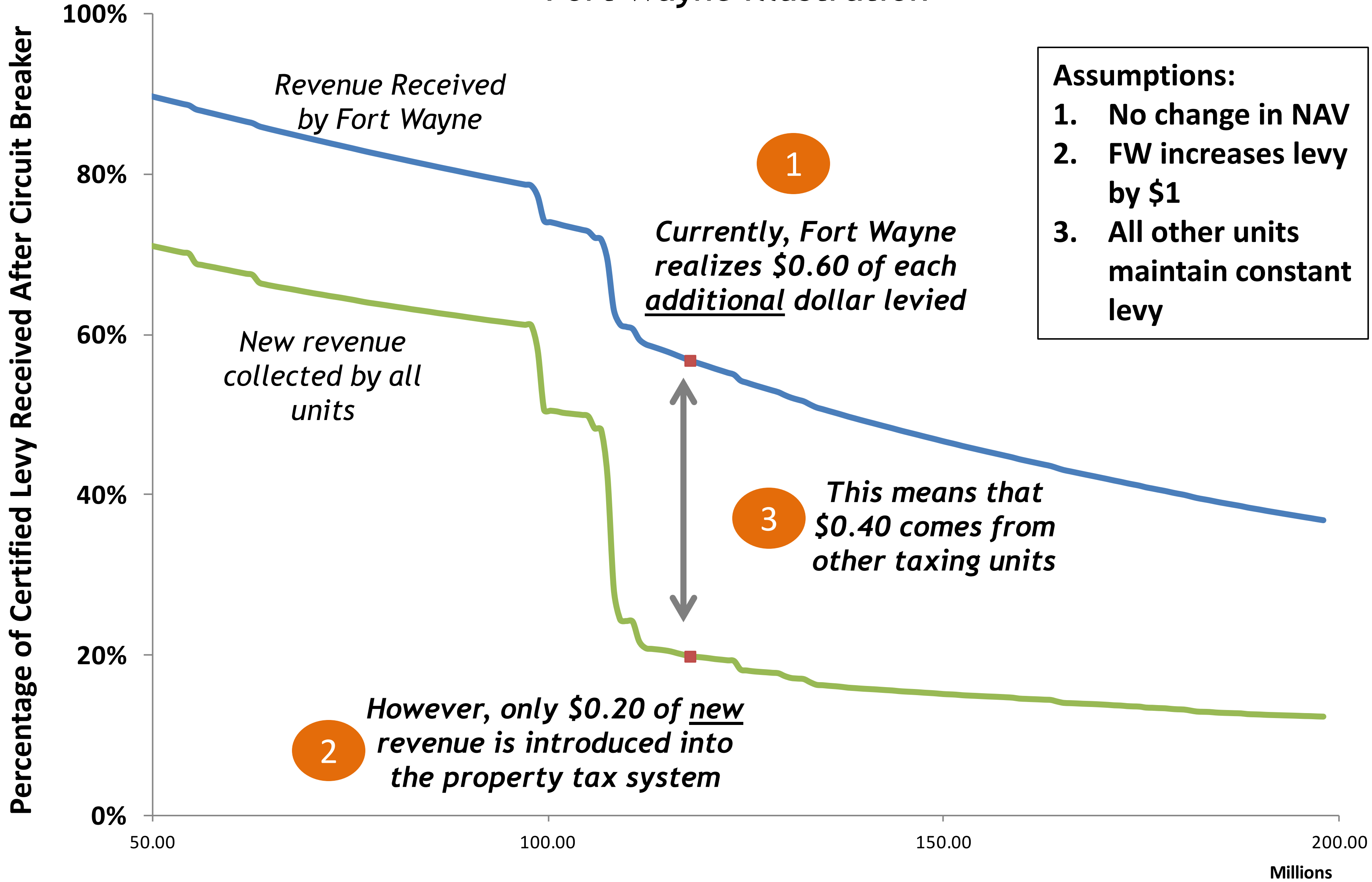
Tax rate exceeds 3%. Parcel hits the circuit breaker cap and pays a max of $3K

Distribution of Tax Payment



Marginal Impact of a $1 Change in Levy

Fort Wayne Illustration

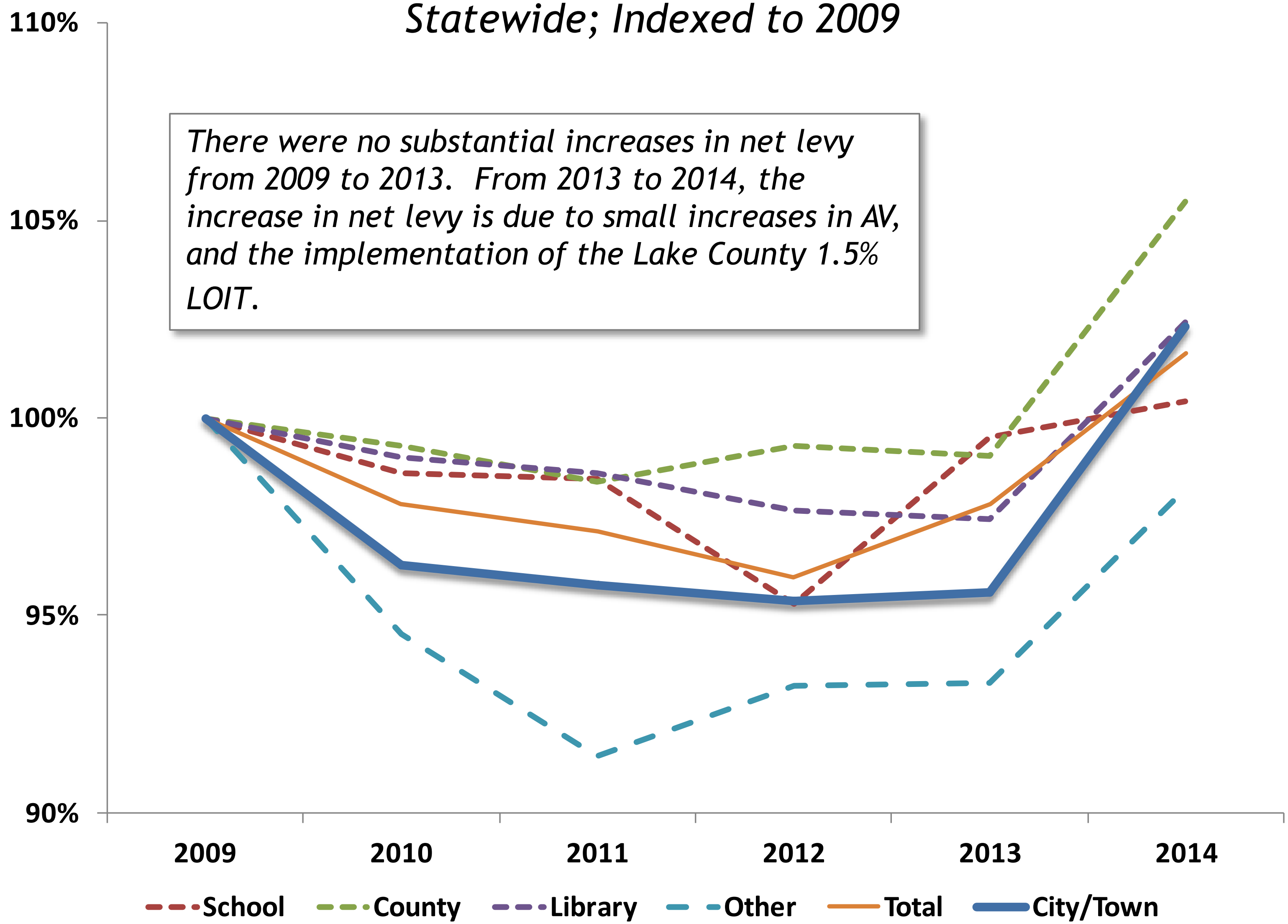


Assumptions:

1. No change in NAV
2. FW increases levy by $1
3. All other units maintain constant levy

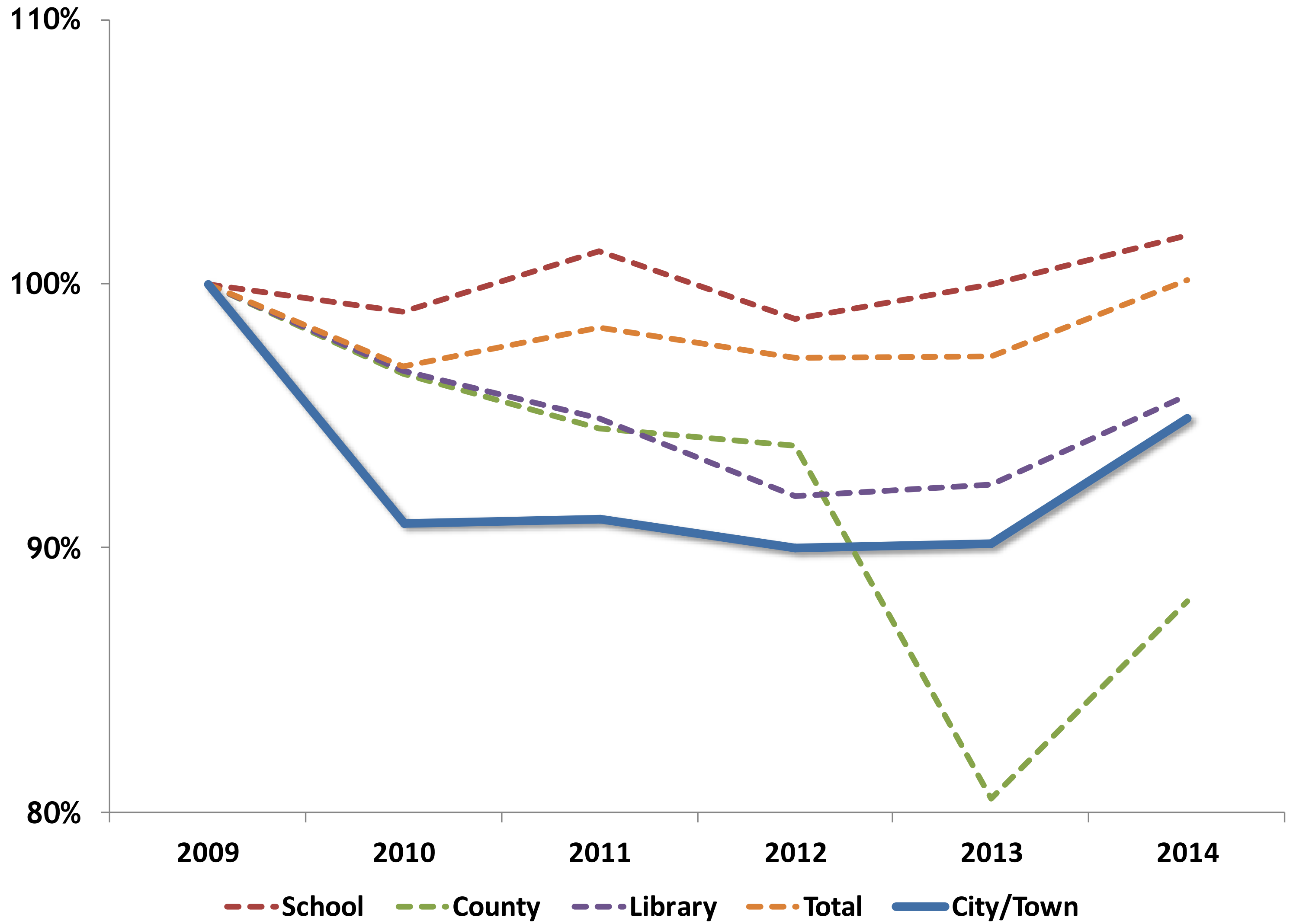
Change in Levy Net After Circuit Breaker

Statewide; Indexed to 2009



Change in Total Budget Net of Circuit Breaker

Statewide; Indexed to 2009



Effect on Local Budgets (2009 to 2014)

- Budgets for cities and towns (what municipalities ask for) have grown by just over 3%; averaging less than 1% annually.
- The amount of budget lost to circuit breaker credits has grown from 2% to almost 10%.
- The funded budget (what municipalities have received), net of the circuit breaker tax credits, has DECLINED by 5% during this time period, or 1% annually.
- While funding has declined, the cost of providing local services has increased nearly 10%.

Implications for Municipalities

Created a financial interdependency of all local schools and local governments that has resulted in a competition for funds among taxing units, including such areas as:

- Issuance of debt
- Creation of tax increment areas
- Capture of incremental assessed values
- Tax abatement
- Annexations

Implications for Municipalities

Creates uncertainty in predicting revenues available to fund local budgets.

- Because of the budget timeline, actual circuit breaker losses are not known until months after the budget process has been completed.
- Encourages taxing units to levy property taxes to maximum levels to minimize revenue shifts among competing taxing units.
- Defers financial commitments to invest in programs and infrastructure

Implications for Municipalities

Many factors that increase circuit breaker tax credits are beyond the control of the affected taxing unit.

- Increases in the property tax rate of one taxing unit reduce property tax revenues collected by another.
- Trending adjustments and assessments reflected in total tax rates are developed by county assessor.
- Adoption of new Local Option Income Taxes to reduce property tax rates and tax credits may likely require legislative action by other elected bodies.
- Economic development activities that increase tax base may be within the jurisdiction of others or may be opposed by other taxing units.

What is the Outlook for Municipal Finance?

Managing the Circuit Breaker Credit

Exercise local budgetary policy options

- Implement options within current levy structure
- Cut levies to reduce shortfalls
- Expand the tax base and facilitate growth

Adopt a new LOIT for property tax relief or public safety purposes

Down the road: Planning for the elimination of business personal property assessment.

Budget Options Available to Local Units

Each taxing unit can manage the revenue shortfalls within their authorized levies

- Reduce spending in anticipation of revenue shortfalls
  - Improved efficiencies and cost sharing with other units
  - Reduced level of public services
- Develop fees and charges to replace lost revenues
  - Adopt user fees where appropriate
  - Consider payments in lieu of taxes for tax-exempt properties based upon value of services provided
- These changes benefit only the taxing unit making the change

Budget Options Available to Local Units

Each taxing unit can manage the revenue shortfalls by reducing authorized levies

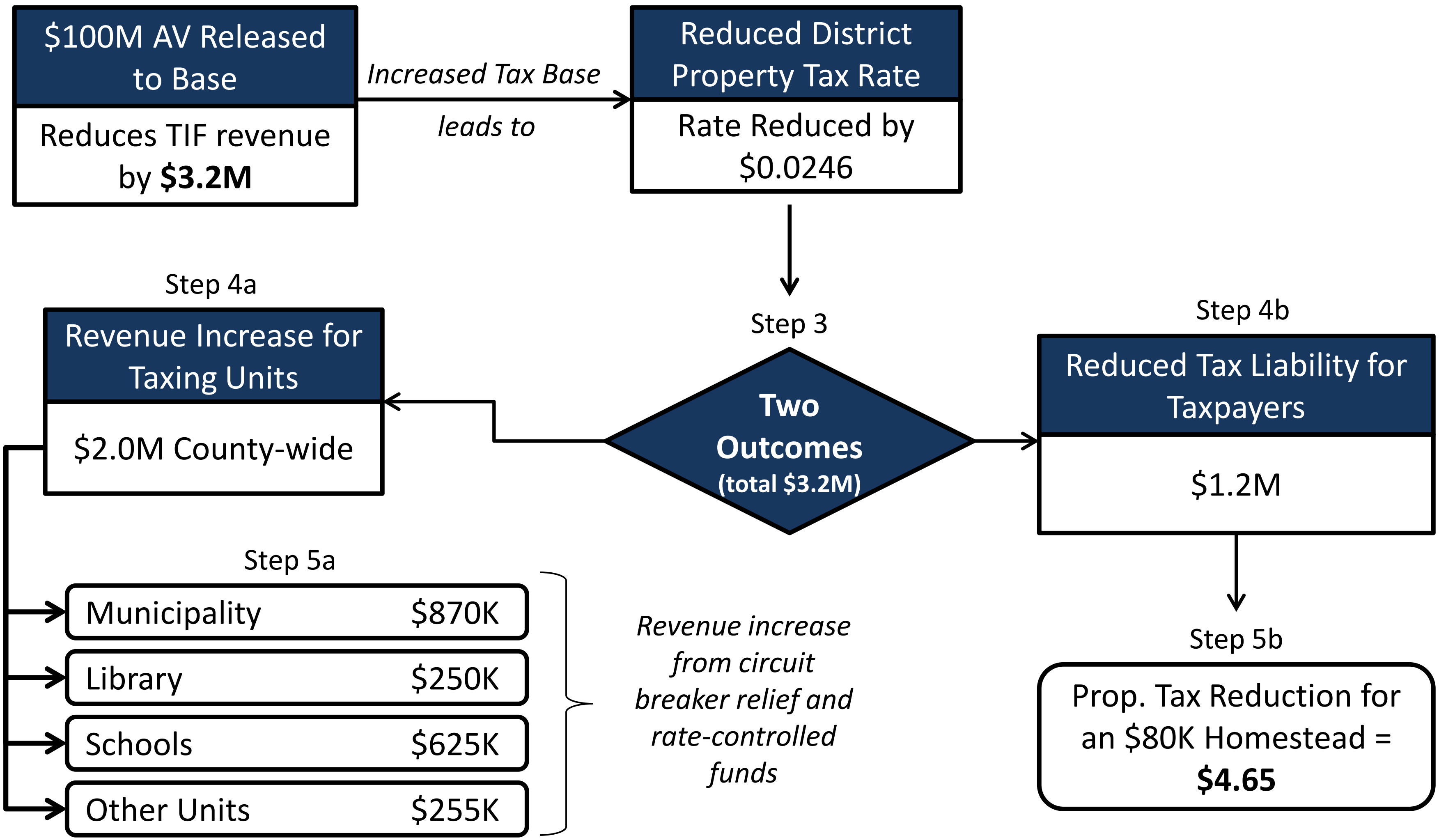
- Result is the reduction in property tax rate which decreases the circuit breaker tax credits of all overlapping taxing units
- Disadvantage is that the taxing unit will only benefit to the extent that these levy reductions actually reduce tax credits; and then, only in proportion to their tax rate
- Some of the resulting savings in circuit breaker loss will accrue to other taxing units.

Budget Options Available to Local Units

Expand the tax base to reduce tax rates:

- Release of excess captured assessed value within tax increment allocation areas
- Modification of guidelines for future property tax abatement
- Consolidation of service territories
  - Fire protection territories
  - Consolidation of other public safety functions
- Annexation

Illustration of TIF Pass-Through Revenue Impact



Legacy Income Tax Options

County Adjusted Gross Income Tax (CAGIT)

- Provides property tax relief and additional revenues to units.
- Adopted by the County Council

County Option Income Tax (COIT)

- Provides new (non-property tax) funding for civil units
- Adopted by the COIT Council
- Can include a homestead credit

County Economic Development Income Tax (CEDIT)

- Available to civil units for any budgetary purpose
- Adopted by County Council/COIT Council

New Local Income Tax Options

Levy Growth Replacement (Levy Freeze)

- Maximum levies frozen in place; growth funded by income tax
- Requires a stabilization fund in the first year (2x the required rate)

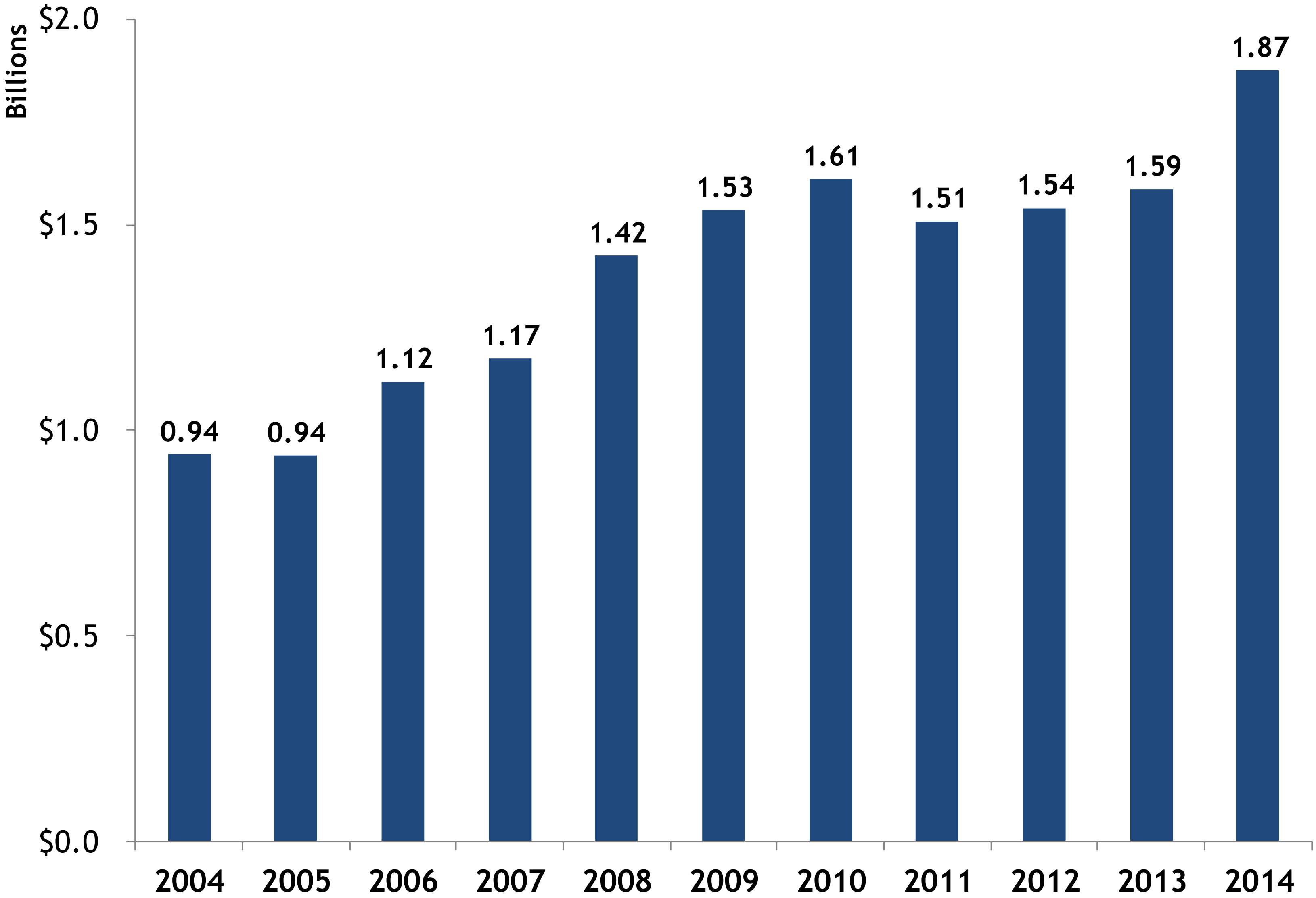
Property Tax Replacement

- LOIT is allocated as a credit against the tax bill
- Three allocation options: Uniform Distribution, Homestead Property, Qualified Residential Property (or any combination)

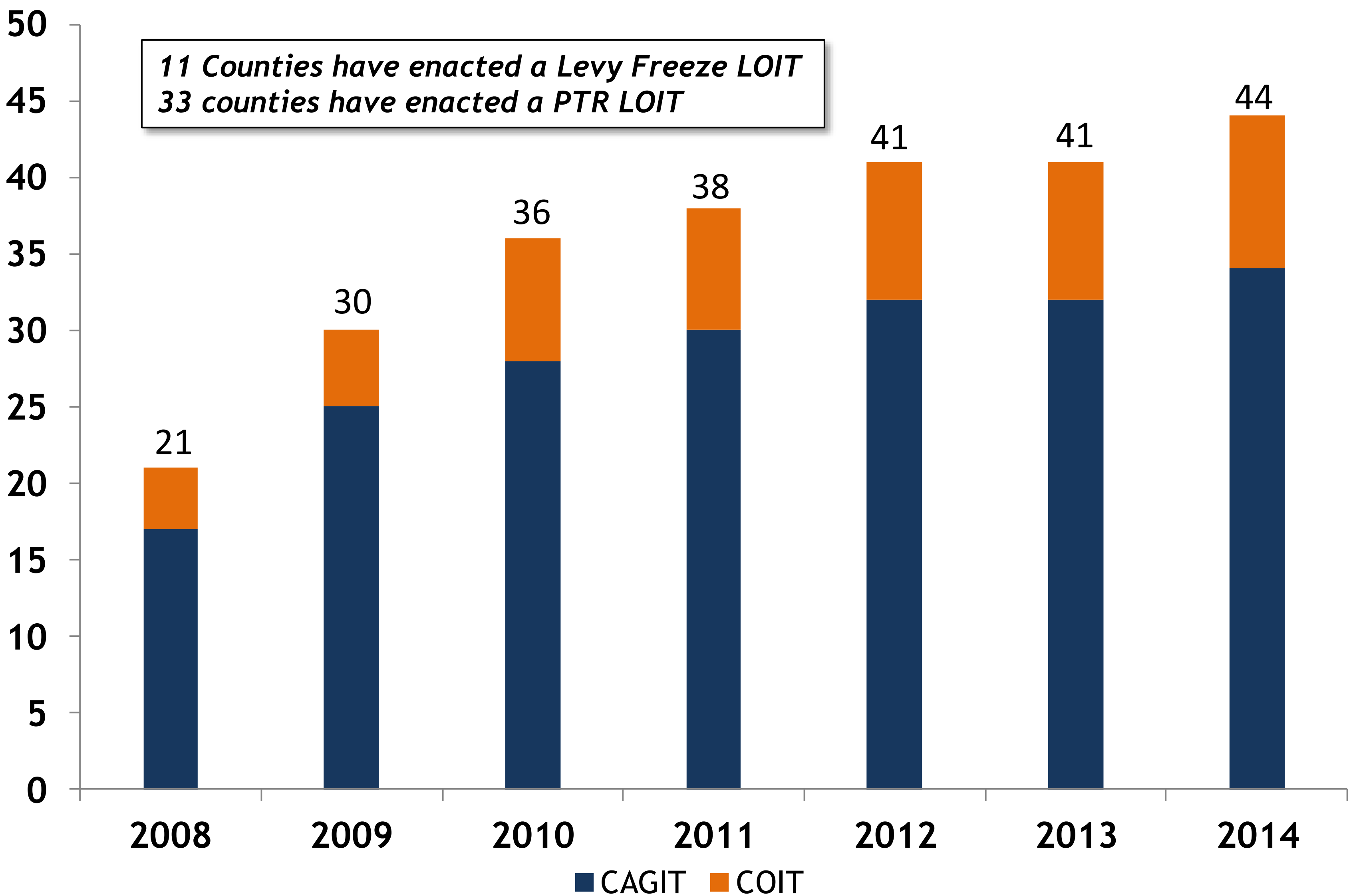
Public Safety Income Tax

- Distributed to counties and municipalities with public safety responsibilities (townships in some cases)
- Must be adopted in conjunction with a levy growth or property tax replacement LOIT.

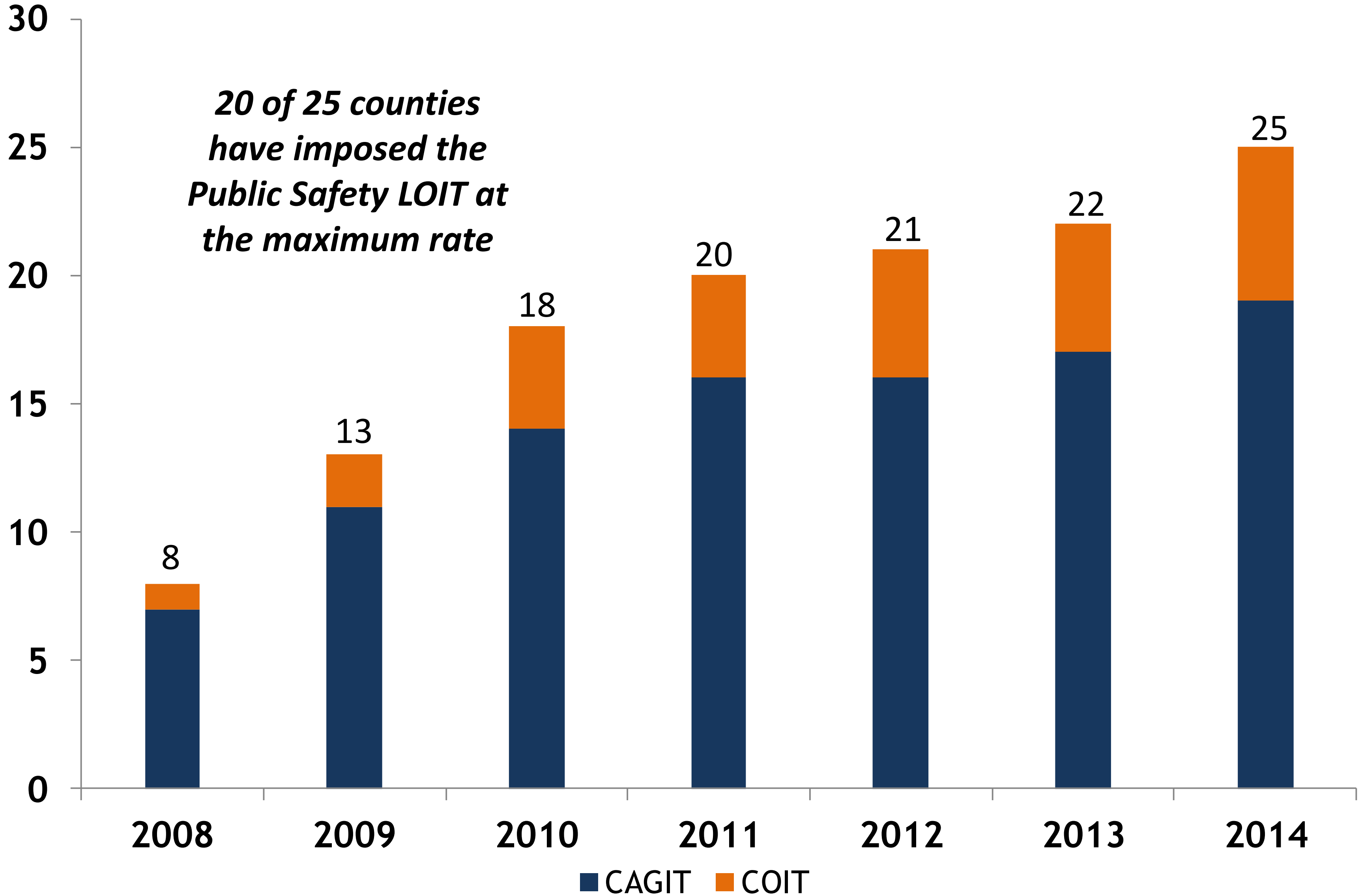
Local Option Income Tax Revenue History



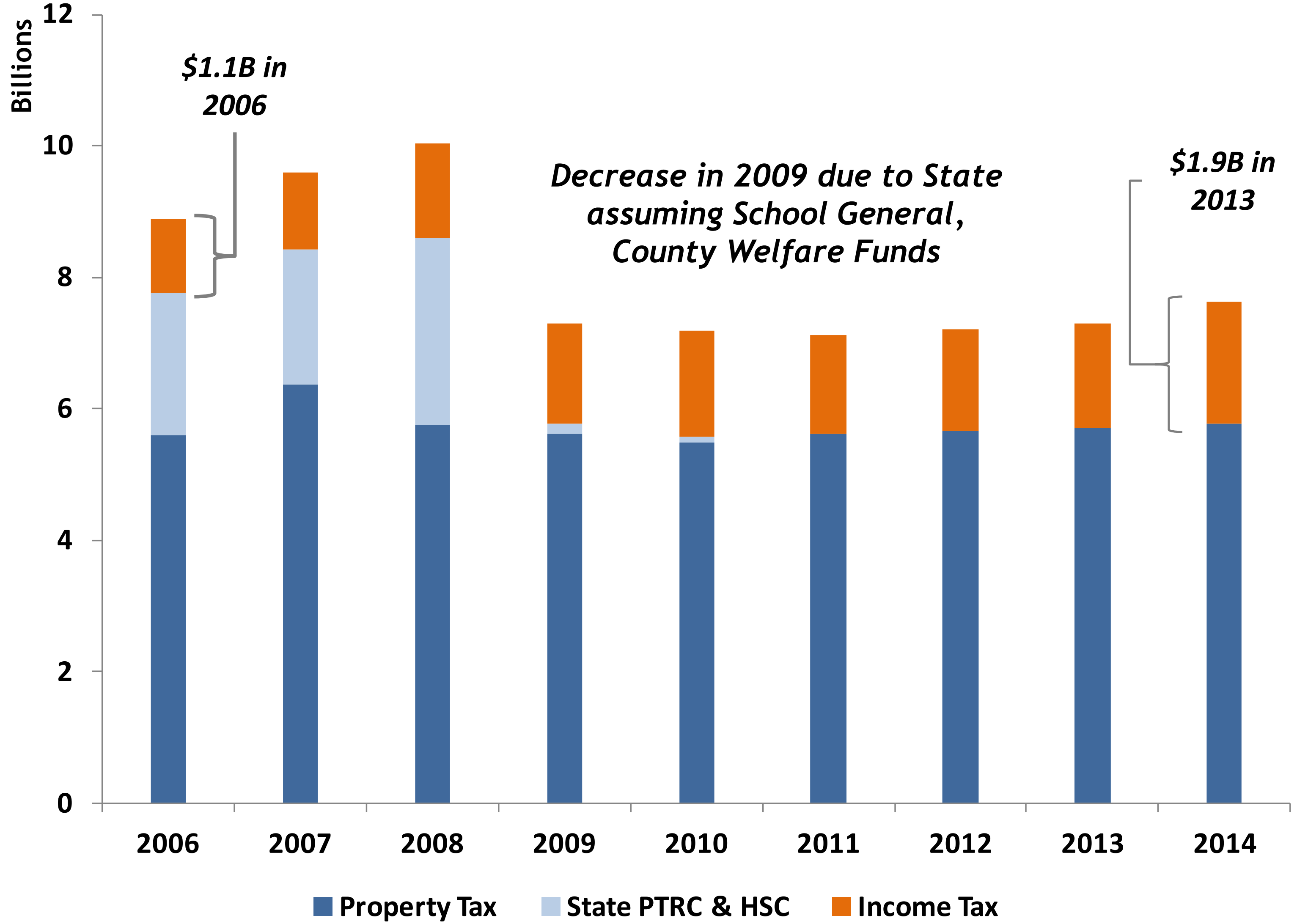
New Property Tax Relief and Levy Freeze LOITS



New Public Safety LOITs



Diversification of Local Government Revenue



Advantages of New LOIT's

Provides flexibility to local units

- Several implementations are available depending on the best fit for the local community.
- Public Safety LOIT provides additional, non-property tax revenue source.

Provides circuit breaker relief to all units

- Legacy income taxes do not provide any new revenue to schools.
- Because property tax relief component reduces effective tax rates, all units benefit.

Provides tax relief to taxpayers under the cap

- Provides benefits to taxpayers in CB-affected areas (more public services).
- Provides benefits to taxpayers in areas without CB problems (lower tax bill)

Limitations of New LOIT's

Not always efficient at mitigating circuit breaker losses

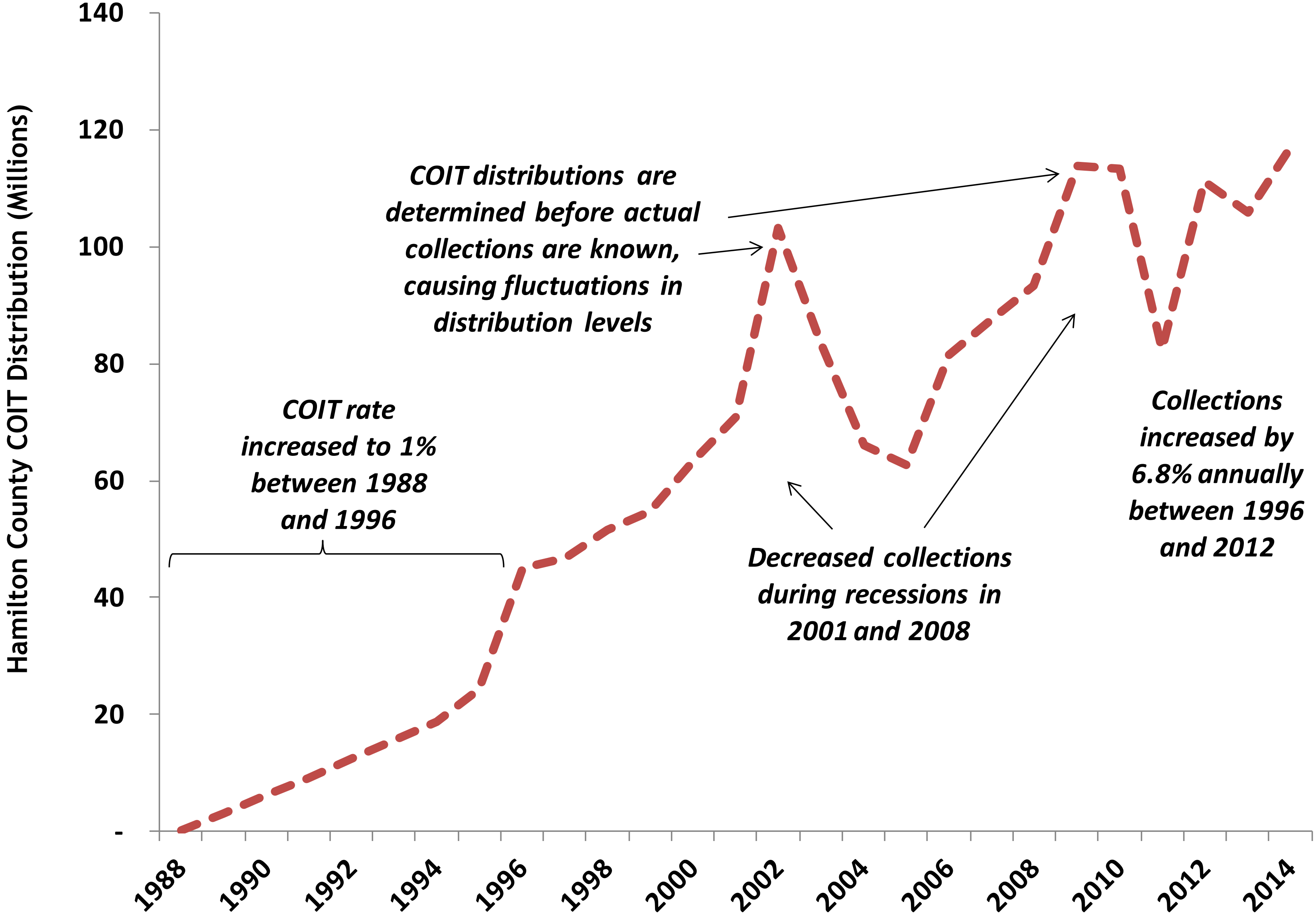
- Because revenue is split between circuit breaker relief and tax relief, higher than necessary rate may be required to mitigate circuit breaker.

Links income tax revenue to property tax revenue

- Revenue forecasting is now a required part of the budgeting process.
- Creates a need to establish and fund adequate cash reserves to offset downturns in the economy.

Equity issues surrounding the source and allocation of revenue

Hamilton County Historical COIT Distribution



Looking Forward: Elimination of Personal Property

Major Provisions of SEA 1-2014:

- Counties have the option to exempt certain types of personal property, beginning in with taxes payable in 2017
- Small returns – investments less than $20,000. These returns make up 50% of the number of personal property tax returns, but comprise 1.7% of the total value of personal property.
- New investment – Exempt new investment from assessment. As older property depreciates, the taxable value will not be replaced.
- Enhanced abatements – allows abatements up to 20 years.

Implications of Business Personal Property Exemption

Findings from the Legislative Services Agency:

- Business personal property accounts for roughly 9% of the total gross assessed property values in Indiana and generates over $1 billion in property tax revenues annually.

- Loss of business personal property tax assessments will increase circuit breaker losses by $566 million and will reduce local tax revenues for rate controlled funds by $153 million.

- The remaining $375 million of lost property taxes would be shifted to other taxpayers

Impact of BPP Elimination on Circuit Breaker

	2015 Losses	2015 w/o BPP	Increase	% Increase
Counties	$98,340,064	$168,936,195	$70,596,131	72%
Townships	24,210,092	39,681,726	15,471,634	64%
Cities & towns	269,718,179	444,284,525	174,566,346	65%
Schools	258,747,426	409,417,838	150,670,412	58%
TIF Allocations	67,060,961	140,877,927	73,816,966	110%
Totals	**$824,965,542**	**$1,381,268,320**	**$566,302,778**	**68%**

Source: Legislative Services Agency, 2013

Impact of BPP Elimination on Circuit Breaker

	2015 Losses	2015 w/o BPP	Increase	%
Angola	107,195	286,781	179,586	167%
Fishers	1,825,832	2,892,310	1,066,478	58%
Indianapolis (Consolidated City)	3,747,579	5,740,267	1,992,688	53%
Kokomo	5,860,051	18,268,239	12,408,188	212%
Lebanon	7,659	97,131	89,472	1,168%
Terre Haute	9,917,469	15,356,064	5,438,595	55%

Source: Legislative Services Agency, 2013

Estimated Impact as a Percent of Levy

	2015 Losses	2015 w/o BPP
Angola	2%	6%
Fishers	6%	9%
Indianapolis (Consolidated City)	15%	23%
Kokomo	13%	41%
Lebanon	0%	1%
Terre Haute	31%	48%

Source: Legislative Services Agency, 2013

What Alternatives Can be Explored?

Possible Legislative Changes

Authorize an additional local option income tax to replace Business Personal Property revenue.

- To replace $1.063 billion of revenues that would be lost from the elimination of business personal property taxes
- LSA estimates that a statewide average rate of .77% would be required to replace all lost revenues

County	Est. Rev. Loss	LOIT Rate
Boone	$5,798,341	0.23%
Hamilton	$34,103,074	0.23%
Howard	$12,580,126	2.32%
Marion	$185,713,045	1.04%
Steuben	$3,452,250	0.50%
Vigo	$23,555,560	1.29%

Possible Legislative Changes

Expand the property tax base to reduce property tax rates and the related circuit breaker losses

- Consider eliminating or limiting exemptions, such as homestead deductions, the supplemental homestead deduction, and non-profit exemptions
- Provide expanded authority for PILOTs to recover costs attributable to non-profit and non-taxed property
- Facilitate efforts to return publically-owned land to the tax base.

Possible Legislative Changes

Provide for the replacement of revenues lost to the circuit breaker tax credits from State funds

- Expand the sales tax base to include services.
- Adopt a business gross receipts tax.

Possible Legislative Changes

Provide more flexibility in the adoption of local option income taxes

- Allow local option income taxes to be adopted by a “super COIT council” comprised of cities, towns, counties, and schools
- Allow changes in the type of local option income tax selected, without a year’s delay
- Allow for the adoption of a municipal income tax

Possible Legislative Changes

Consider the consolidation of the several forms of local option income taxes authorized today.

- Reconsider the current allocations of income tax revenues among taxing units and the current use of those funds.
- Eliminate duplicative tools (i.e. CAGIT, COIT Homestead, EDIT inventory replacement and LOIT property tax replacement all provide property tax relief).
- Make available more funds for local government services

Possible Legislative Changes

Provide more flexibility in the use of local option income taxes

- Permit local option income taxes to be used to directly replace losses resulting from circuit breaker tax credits
- Permit local officials to determine the allocation of local option income tax proceeds for property tax relief, replacement of circuit breaker losses, accumulation of reserves and funding for programs, and capital projects

LOIT Rates Required to Fund 2015 Circuit Breaker Losses

	2015 CB	2015 CB w/o BPP
Boone	0.24%	0.30%
Hamilton	0.28%	0.39%
Howard	0.88%	2.50%
Marion	1.05%	1.73%
Steuben	0.03%	0.09%
Vigo	1.29%	2.16%